

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION

PUBLIC ROUNDTABLE TO DISCUSS PROPOSED RULEMAKING
ENHANCING PROTECTIONS AFFORDED CUSTOMERS AND FUNDS
DEPOSITED BY CUSTOMERS

Washington, D.C.

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8 Dealer and Intermediary Oversight9 TOM SMITH, CFTC, Division of Swap Dealer
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24 MICHAEL GREENBERGER, University of
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1 P R O C E E D I N G S

2 First Session - The role of Examination Experts'

3 Reviews of SRO Examination Programs

4 (9:33 a.m.)

5 MR. BARNETT: We'll get started in one
6 minute. Okay, good morning, everyone. Welcome to
7 the staff's roundtable to discuss certain topics
8 included in our -- in the Commission's proposed
9 rulemaking on "Enhancing Protections Afforded
10 Customers and Customer Funds Held by Futures
11 Commission Merchants and Derivatives Clearing
12 Organizations," that was published for comment on
13 November 14th, 2012.

14 The rulemaking contemplated a 60-day
15 comment period, which has been extended for
16 another 30 days to February 15th, this month. To
17 date, do you know how many letters we're up to
18 now? Over 40, right?

19 MR. SMITH: Seventy.

20 MR. BARNETT: Up to 70 now? All right.
21 So we're currently up to 70 letters, which we will
22 be going through, and, of course, responding to

1 when we get to the final rulemaking.

2 Today's roundtable will focus on four
3 topics that arise out of the proposal. First,
4 we'll look at the proposal regarding the periodic
5 engagement of an exam expert to review SRO
6 examination programs and the execution of those
7 programs to assure that adequate procedures are in
8 place and are being followed properly.

9 Secondly, we will look at the proposed
10 additional reporting and firm disclosures. Third,
11 we will discuss acknowledgment letters for
12 customer accounts and related requirements. And
13 fourth, we'll look at certain proposed
14 requirements regarding customer margin.

15 In terms of housekeeping items, people
16 probably -- the bathrooms and the telephones are
17 out in the back. The first session today will go
18 from now until 11:00. We'll take a 15-minute
19 break. And then we'll have a second session which
20 will go until 12:45, when we'll break for lunch
21 and we'll start again at 2:00 for the third
22 session. We'll go to 3:15, take another break,

1 and then go into the fourth session. We'll end by
2 5:00 today.

3 The typical disclaimer in this
4 roundtable, staff may express views and thoughts
5 on various topics. Any of us might do that. And
6 that person's views and thoughts are those of the
7 individual, not those of the Commission, or any of
8 the commissioners, any division, or staff
9 generally, or any other staff.

10 Okay. So let's get the first session
11 started, focusing on the exam expert. We're
12 extremely grateful to have this Panel with us.
13 Thank you so much. Let's go around the table
14 quickly stating name and company affiliation.
15 Then we'll start here, and then we'll come around
16 and we'll include the staff at the end.

17 MR. FLOWER: I'm Rich Flowers from Grant
18 Thornton.

19 MR. BARNETT: Thanks, Rich.

20 MR. JAMROZ: Mike Jamroz from Deloitte
21 and Touche.

22 MR. MCISAAC: Dan McIsaac, KPMG.

1 MR. PALUMBO: Joe Palumbo, Ernst &
2 Young.

3 MS. BAGAN: Anne Bagan, CME.

4 MS. VOGEL: Grace Vogel, Financial
5 Industry Regulatory Authority.

6 MS. THOELE: Regina Thoele, National
7 Futures Association.

8 MR. TELZER: Sam Telzer, Price
9 Waterhouse Coopers.

10 MR. STEVENSON: Michael Stevenson,
11 Public Company Accounting Oversight Board.

12 MR. NUNERY: Cam Nunery, Office of the
13 Chief Economist, CFTC.

14 MR. SMITH: Tom Smith, the Division of
15 Swap Dealer and Intermediary Oversight.

16 MR. BARNETT: Gary Barnett, Swap Dealer
17 and Intermediary Oversight.

18 MR. PICCOLI: Kevin Piccoli, Division of
19 Swap Dealers and Intermediary Oversight.

20 MR. BARNETT: Great. All right. So I'm
21 going to start with -- we have a lot of
22 accountants here. I'm going to start with a

1 non-accountant-speak question, and then I'm going
2 to turn it over to my colleagues and let them have
3 at it with you all.

4 MR. PICCOLI: Get the lawyers out of
5 the way.

6 MR. BARNETT: Yeah, no, get the lawyers
7 out of there, right.

8 MR. PICCOLI: Have some good
9 conversation.

10 MR. BARNETT: Right. So our proposal
11 seeks to have an exam expert periodically review
12 the Joint Audit Program and the execution of the
13 program in the examination of FCMS, and to take a
14 view about the adequacy of both, the program and
15 its execution. Can we get that sort of review and
16 assurances from an exam expert? Can we get what
17 we're looking for?

18 MR. PICCOLI: Okay. Let me, I guess,
19 just sort of kick it off with -- I want to just
20 try to cover a bunch of different topics here.
21 One, what type of reports can be issued going
22 through the number of different possibilities that

1 are out there. Are there any difficulties in
2 issuing such a report? What standards do we need
3 to consider to measure against, because any report
4 we need to have something to measure against in
5 order for an exam expert to report upon. Then
6 talking about the scope of the report, timing and
7 costs, and then what would be, you know,
8 qualifications of an exam expert? What should we
9 be looking for in an examination expert?

10 So let me just start off with the
11 initial, you know, what type of report could be
12 issued. So let me, I guess, throw it out to the
13 panelists for specific thoughts on the types of
14 reports that we could issue that would accomplish
15 our objectives? So would anyone like to start?
16 Joe?

17 MR. PALUMBO: Yeah, thank you, Kevin.
18 We thought a lot about this, and based on what I
19 think the Commission is trying to accomplish here,
20 thinking through the different types of reports
21 that can be issued, a findings and recommendations
22 report comes to mind, and that's under Consulting

1 Standard 100. That's AICPA CS100. It gives the
2 opportunity for the examination expert, using a
3 prescribed set of guidelines or certain standards
4 that we're asked to look at, to provide for
5 findings and maybe industry recommendations on
6 ways to improve, enhance, or think about ways to
7 incorporate best practices that we might see.

8 So that consulting CS100 findings and
9 recommendations is something that's used widely in
10 practice, and could possibly fit the bill for what
11 you're looking to do.

12 MR. TELZER: Kevin, I think maybe
13 there's a framework we should start with, because
14 Joe rightly points out the consulting standard.

15 So the rules right now as proposed talk
16 about an attestation, and an attestation has a
17 meaning within the literature, which is there's a
18 set of standards issued by the American Institute
19 of CPAs that refers to attestations. And within
20 that, there are four broad-based attestation
21 concepts. There's AT 101, which is referred to
22 broadly as attestation engagements. There's AT

1 201, which is agreed upon procedures. There's AT
2 601, which is a compliance attestation, and
3 there's AT 801, which is reporting on controls at
4 a service organization. AT 801 used to be known
5 as SAS 70. It was reorganized in the last few
6 years to be under the attestation.

7 The thing with an attestation, except
8 for AT 201, which is agreed upon procedures, is it
9 is a report by a CPA over management's assertion.
10 So management asserts that it has a certain set of
11 controls. The CPA tests those controls, and then
12 opines on whether or not those controls are
13 operating as either designed, which would be a
14 type one, or as designed in operating, which is a
15 type two report. So again, you have stripes and
16 flavors depending on what you want.

17 I think one of the questions is, and I
18 should say, by the way, AT 201, agreed upon
19 procedures results in no opinion. It is literally
20 procedures agreed upon on on which a report is
21 issued.

22 So one of the questions that I really

1 pose is, what does the Commission want, because if
2 you want an opinion, you somewhat put yourself
3 into the attestation bucket. If you want a report
4 on findings and recommendations, as Joe properly
5 points out, you put yourself in the AICPA
6 consulting standards bucket. Either one is fine.
7 We can do those type of reports. It's really a
8 question of what do you want.

9 MR. FLOWERS: I think, Sam, the key
10 should be that we actually go through the flow of
11 how the auditing standards work to get to either
12 -- you get to either a 601 or potentially a --
13 reverting back to a 101, and then you get an
14 exception to the statement of standards for
15 consulting standards.

16 So I have a chart here that I could
17 probably pass that to Kevin to how exactly this
18 works. On the chart it indicates what the type of
19 attestation standard -- other attestations
20 standards decision flow for financial statements
21 internal controls, service organizations and AUP,
22 and other procedures. And the first question is,

1 is the subject matter material related to the
2 financial statements? The answer to that is no.
3 So then you go over to the next question, which
4 says, is the subject matter related to reporting
5 on internal control? And the answer to that, say,
6 well, yes. And then you say, are the controls
7 related to the service organization that provides
8 services to other parties? And the answer to
9 that, maybe yes.

10 But actually you're going to go up and
11 eventually you're going to get to the -- is this
12 an agreed upon procedures report. And the answer
13 to that would be no if we don't have one. And the
14 next question is, is the subject matter compliant
15 with regulations from a contract or grant? So if
16 it's from a -- it's relative to a compliance with
17 a contract or an actual report that could be
18 possibly your section that you developed here for
19 exposure. But if the answer to that is -- so that
20 would be on the regulation 1.52. But if you don't
21 need that, if you don't really say it's not 1.52,
22 we're not going to do compliance with that.

1 If it was going to be compliance with
2 that, that would be in AT 601. If you don't get
3 that, then you drop down to the question of the --
4 is the subject matter a discussion, an analysis
5 under SEC rules and regulations? No. And you go
6 through all these decisions, and you revert back
7 to AT 101. That's the only other place.

8 When you go to AT 101, it says under AT
9 101 that the reality is there are actually some
10 exceptions associated with AT 101. And one of the
11 exceptions is that you get a statement of
12 consulting standards as part of the exception you
13 would have to issue a report on. So it reverts
14 back to exactly what Joe had said and what Sam had
15 said. If you're going through the actual
16 regulations for that chart that I just gave you,
17 you'll get back to either a statement of
18 consulting standards, which could be a report.
19 It's not an opinion or anything like that. It's
20 just a report, a statement of what we actually
21 did.

22 The alternative is if this really is in

1 accordance with these regulations, this Rule 1.52,
2 then it could be a 601 type report. In either
3 case it would be a -- not be an attestation
4 report, but it would be a report describing what
5 exactly you wanted. And I think that's really up
6 to you, as Sam has said, that really the question
7 is, what do you really need? And we want to be
8 responsive to that, and we found the chart that
9 goes through -- gets to that position.

10 And I think that just to clue a little
11 bit on that, I think Regina has just gone through
12 this with respect to the report by the Berkeley
13 Research Group. The NFA engaged them to actually
14 do a report. It appears to be a consultation
15 report and includes various areas that would
16 relate to both the Joint Audit Committee's
17 positions on how the NFA should actually perform
18 their audit. But it also includes a number of
19 references to auditing standards and to the PCAOB
20 standards, but it is not specifically referred to
21 as being in compliance with either the auditing
22 standards or the PCAOB standards. But it's a

1 consultation report selecting appropriate
2 components for that as a guideline.

3 And I would say that the appropriate
4 components you could either encompass into our
5 Rule 1.52 or just leave it up to discussions with
6 whatever firm you can get to that. And I think
7 that that would focus on risks the extent that you
8 want it to. And I think that a consultant's
9 report on that would be appropriate. And included
10 in that risk report might be a little bit better
11 description of really what the work is when we
12 evaluate risk.

13 They make reference to the auditing
14 standards. I think that the example of the types
15 of audit procedures are procedures that are
16 performed when evaluating risk would be
17 appropriate. And Sam could talk about this to
18 great length, but it's to test the general entries
19 and things of that nature that really apply to the
20 audit of risk.

21 MR. PICCOLI: All right. Thank you,
22 Rich. That's very helpful.

1 MS. BAGAN: I actually have a more
2 fundamental question, getting back to the basics
3 of what is it -- I guess to Sam's point, what are
4 we trying to do here? Why do we need to have this
5 done?

6 As you know, we update our Joint Audit
7 Committee Programs every year, and the CFTC Staff
8 obviously participates in those meetings as well.
9 And we try to encompass industry trends or
10 developments, and we welcome suggestions from
11 anybody on the committee or the CFTC for new steps
12 that we should look at.

13 This year we actually didn't wait for
14 the end of the year. We implemented a number of
15 new steps mid-year. And so I guess I'm just
16 confused what exactly we are trying to accomplish
17 here.

18 As you know, as far as implementation
19 goes, your staff is in our department every
20 quarter looking at our audits or our examinations
21 and looking to make sure that we are following the
22 standards, the Joint Audit Committee standards,

1 and the programs, and make sure that we are
2 implementing and coming to reasonable conclusions
3 on those examinations.

4 MR. BARNETT: So, Anne, so basically
5 your view is that the status quo is okay, that
6 what we're doing is sufficient and it will get the
7 changes that we need in as it is. Is that what
8 you're suggesting?

9 MS. BAGAN: Well, I don't know that we
10 need an exam expert to come in and tell us what it
11 is that we need to implement in our programs. As
12 I said, we welcome any suggestions on ways that we
13 can enhance our programs.

14 MR. BARNETT: Okay, thanks. I'm going
15 to go back to a non-accountant question again. So
16 in terms of the different methods you guys were --
17 and the reference to the Berkeley report -- I
18 mean, so it was a review of practices, and
19 procedures, and the execution of those procedures
20 to assure that adequate procedures are in place
21 and that they're being followed properly. But it
22 was in the -- that was how it was stated as the

1 task, but then -- and then it had a bunch of
2 recommendations. Now with that goal and then the
3 recommendations, I guess that's a consultation
4 type report.

5 And then how would it differ it was an
6 opinion? I want to understand the differences a
7 little better.

8 MR. TELZER: Gary, to try and respond,
9 the attestation reports that result in an opinion
10 on the management assertion would be a recitation
11 of what was done and whether or not the controls
12 as described or the tests as described were
13 operating. It would then result in a finding if
14 the controls were not operating as described. So
15 you would get the -- if you will control the
16 description and if it was not operating, you'd get
17 a finding out of it, except in the attestation
18 case under AICPA standards, you're getting the
19 opinion -- and that's why I asked the question is,
20 do you want an opinion -- with a consultative
21 report, which is what you see coming out of the
22 Berkeley Group. That is more -- the consultative

1 report does not have the opinion on it.

2 So really the question is, it's a more
3 free form report, if I want to use that term,
4 because it allows the author of the report to
5 describe what was done and how it was done.

6 The AT reports -- AT 101 and the like,
7 are more prescriptive in the format they follow,
8 and if you actually look at some of the reports,
9 which you can go, ask some of your registrants --
10 they get SSA 16 reports and AT 101 reports for a
11 variety of reporting matters -- you could see the
12 difference between what they get when they engage
13 someone to opine on either segregation or on
14 custody or things like that versus what happens
15 when you get a consultative report issued under
16 the consultation standards.

17 And really the question I ask again is,
18 if you want an opinion, an opinion says that
19 management's assertion about their control
20 environment is accurate, and that there were no
21 exceptions detected, or if there were, then you
22 almost are forced into the AICPA attestation

1 standards. If you say I don't want an opinion,
2 then you have more free form flexibility using the
3 consultation standards.

4 MR. JAMROZ: Gary -- I'm sorry to
5 interrupt.

6 MR. TELZER: Go ahead.

7 MR. JAMROZ: Going back to the basics --

8 MR. BARNETT: One thing, so Mike Jamroz.

9 MR. JAMROZ: Mike Jamroz at Deloitte.

10 MR. BARNETT: We have to for the
11 transcript.

12 MR. JAMROZ: I don't know much about the
13 Berkeley Group. I think they're bound by our
14 standards. And while we would look at a report
15 that they produced and looking down the list of
16 things that we can do, it most closely resembles a
17 consultant's report, you should understand --
18 first of all, I think there are limitations on the
19 distribution of our consulting reports. I think
20 we can only give them to management. We can talk
21 later about instances where we share them with the
22 regulators or the company. But we would not make

1 it public the way the Berkeley Report was public,
2 so I think that's important to note.

3 And the other thing you should note is
4 that while I think that the comparisons drawn in
5 that report to auditing standards are useful, you
6 should also realize that the examiners of the NFA
7 and the CME and other SROs are not doing a GAAP or
8 GAAS examination/audit. So I think later -- and I
9 think some of the questions you asked about best
10 practices, I think the standards that they refer
11 to are more appropriately thought of in terms of
12 either best practices or something to the extent
13 that certain practices may -- because I don't know
14 that all of the auditing standards would be
15 applicable to these exams, but some of them
16 certainly offer information that would be helpful,
17 you know, to use. So I think it's important to
18 think in those terms.

19 MR. TELZER: And if I could just add on
20 to what Mike said because I think those are very
21 good points, we haven't gotten to distribution,
22 which is really what Mike brought up, is that when

1 you look at reports that can be, I'll call,
2 circulated, attestation reports, aside from agreed
3 upon procedures, are generally available to
4 customers and clients of or consumers of the
5 information so that the distribution restriction
6 is lower, if you will, than it is with other type
7 of reports.

8 If you go into the consultation
9 standards, and Mike properly points out, that is a
10 report that really has restricted distribution.
11 It is only meant to be used by the management of
12 the entity. And when you start adding the facet
13 of availability to regulators, that engenders a
14 whole different discussion about what do the
15 regulators get and what form does it get shared,
16 what level of sharing occurs. Is there privity to
17 the work papers? There are a lot of different
18 issues that come into that consultation.

19 MR. PICCOLI: Yeah, I think that's an
20 excellent point, Sam, and I think if we can just
21 table that for a second, then we'll get to that a
22 little bit later. But just to try to just

1 continue on this type of report.

2 So going to a findings and
3 recommendations in a consultative type report, if
4 there are findings that come out of that report,
5 it's basically just left, okay, here's what we
6 did, here's what we found, here's our
7 determination. And then it's up then to the, in
8 this case, the DSROs to respond and react to that.
9 There's no requirement for the DSROs to say, okay,
10 we understand your recommendation, here's what
11 we're going to do to meet that recommendation. Is
12 that correct, or is that something we could put
13 in?

14 MR. MCISAAC: Yeah, that's correct,
15 Kevin. But I also think who would the experts be
16 working for, the DSROs or the CFTC? And I think
17 that has the bearing on how the reports come out
18 and what we can do with them. If we're working
19 directly for the DSROs, it's different than if we
20 were working for the CFTC, reviewing it for the
21 CFTC's purposes. You can then lay the ground work
22 of what you want us to look at as opposed to

1 working with the DSROs and how we're going to work
2 with them.

3 MR. PALUMBO: And to your point, Kevin,
4 I've seen finding and recommendations reports
5 where management was given an opportunity to
6 respond to the findings and recommendations with
7 its own thoughts. And if that's done
8 appropriately, I've seen that done in the -- under
9 the standard.

10 MR. TELZER: And, Kevin, if I could just
11 say one other thing. You brought up the issue of
12 the findings and recommendations, which Joe and
13 Dan both spoke about. When you have someone write
14 a report, it is really up to the organization the
15 report is issued on as to how they implement or
16 change based on the remedial recommendations.

17 The people sitting around this table
18 have no regulatory or statutory authority to
19 require anybody to do anything. So just think
20 about that as you go through these rules, which is
21 that you need what I'll call an accountability at
22 a certain point for the recommendations because

1 the recommendations are a negotiated item, but the
2 implementation can't be negotiated. That has to
3 be something that everyone agrees needs to happen,
4 the time frame and responsibility, and the cost
5 benefit for those.

6 MR. PICCOLI: Sure, I think that's a
7 valid point, Sam, and I would suspect, though,
8 that any recommendations that come out would be
9 something that at the end either there's full
10 agreement and it's, yes, okay, that makes sense
11 and here's what we're going to do to respond, or
12 if there's not, then, okay, we don't, and here's
13 why we don't, which can be an acceptable answer as
14 well. But your point is well taken, Sam. Thank
15 you. Yeah.

16 MR. BARNETT: So if I were a third party
17 observer, I look at the report. I see the scope,
18 you know. We want the independent -- the expert
19 looks at the procedures in place. They look at
20 how they were executed, and they've made some
21 recommendations.

22 And then accountability. The

1 institution or the JAC or the DSROs, they look at
2 the recommendations. The CFTC's involved in the
3 discussion. We have to come back to this question
4 about who's working for who. But look at the
5 recommendations, and let's say some of them deal
6 with best practices, but they're lifted maybe from
7 a prudential regulator context, or for some reason
8 we don't take on those particular recommendations.
9 We do nine out of 10 of them. And then there's a
10 blowup. What should be inferred from the fact
11 that a recommendation was not taken on, anything
12 or that's just considered in the context of the
13 accountability, the consideration that was given
14 to the recommendation and the decision whether to
15 follow it or not? How would I look at it
16 afterwards in looking at the fact that this
17 institution engaged in this examination or this
18 review, and then decided maybe not to follow every
19 single one of the recommendations?

20 MR. TELZER: Well, Gary, I would offer
21 that when you read the report, as you say, as a
22 consumer, depending on what report -- what style

1 of report you're looking at, it probably will not
2 have best practices. It will be very ritual
3 based, which is that this is what is being done,
4 this is what needs to be done. And it would be
5 very fact based.

6 So if there is a prudential regulator
7 concept that needs to be brought in, that would be
8 depending on the type of report, that would be
9 brought in based on the style of the report that
10 would result in a recommendation.

11 MR. BARNETT: Oh, excuse me. So then
12 let me just change. I just picked an example.
13 I'll pick another example, but one that would
14 properly be among one of the recommendations. And
15 the JAC looks -- everyone looks at it and decides,
16 you know, a lot of these make sense. This one,
17 for whatever reason -- cost benefit, or likelihood
18 of adding that -- for some reason they decided
19 after good consideration that they weren't going
20 to take that one on, how should the decision be
21 reviewed in the aftermath, let's say, of not
22 taking on a recommendation?

1 MR. TELZER: I'll go back to what I said
2 earlier is that the people you have around this
3 table as the panel generally don't have the
4 authority to require anything. So if it's an
5 agreement that there's an issue that results in a
6 recommendation, then the organization that gets
7 the recommendation would have to formulate an
8 action plan.

9 That action plan may say cost benefit
10 means right now, no, it may not be practical.
11 There could be a host of reasons why something
12 does or does not happen. But I would really leave
13 it to the consumer of the report to determine how
14 important that item is. And in this case, if the
15 consumer is other than the DSRO, but also the
16 CFTC, then you might have to make your own
17 independent determination of that recommendation,
18 and then see whether or not you wanted something
19 more robust than what the DSRO was agreed to do in
20 that instance.

21 MR. BARNETT: Okay, thank you.

22 MS. THOELE: Can I just add to that? I

1 guess the question would be then at that point, is
2 it the JAC sitting with the CFTC, if the CFTC is
3 part of the JAC? And then what becomes public if
4 we do decide, and not assuming that there would be
5 a recommendation that we wouldn't want to do. But
6 assuming there was, is there some type of public
7 record of what analysis we went through and why we
8 chose not to put a recommendation into play? And
9 I don't know what that process is.

10 MR. PICCOLI: Yeah. And just to be
11 clear, I do not believe -- and, Tom, correct me if
12 I'm wrong -- that the CFTC is not an official part
13 of the Joint Audit Committee. We're invited into
14 certain sections and asked to it, but we're not an
15 official member of the Joint Audit Committee.

16 But putting that aside, Regina --

17 MS. THOELE: Just to clarify that we do
18 meet and discuss the program changes, so correct.

19 MR. PICCOLI: Absolutely, yes.

20 MS. THOELE: And then just -- I would
21 assume that that would be something that we would
22 work together to make the decision.

1 MR. PICCOLI: Absolutely, right. Yeah.
2 And I think we would all want to make sure that
3 any decisions were thoughtful and with the proper
4 analysis and, you know, a consensus reached as to
5 the right way to employ or engage in any type of
6 recommendation.

7 MR. TELZER: Could I also offer one
8 other thought, is, again, depending on what type
9 of report you decide you might want, and this is
10 going to tee off a little bit of what Regina
11 brought up, the availability of that report in the
12 public domain could contain confidential
13 information, could contain things that cause
14 people who deal with that organization to not have
15 the context of the recommendation. And depending
16 on how that information is made available, that
17 needs to be thought about and at what point it's
18 made available.

19 MR. PICCOLI: So, Sam, I think you bring
20 up an excellent point. I know a couple of others
21 brought that up as well. So why don't we just
22 chat about that for a second, because I know from

1 the PCAOB, they have similar types of reports, you
2 know, looking at accounting firms, and they issue
3 a, I guess, two reports, one that's a public
4 report and one that's private. So it's possible
5 another may be under our own regulations. It
6 could be, of course, it does have confidential
7 information. It could be covered under -- as
8 excluded from public domain because of the
9 confidential information in there. I think that's
10 something we'd have to look at.

11 But is there a possibility of going with
12 a consultative report, splitting it between a
13 public section and a confidential section if we
14 could? Is that something that would be worth
15 exploring?

16 MR. MCISAAC: I don't know. I know from
17 a risk management standpoint, it raises a higher
18 risk for the consulting firm on whether or not
19 it's going to just the management of the firm or
20 to a broader base, and that will have an impact
21 on, you know, what you can do and what you will
22 say. Most part, ours don't go there. They may go

1 to a regulator, but again, it's all kept
2 confidential. It's not something that the firms
3 issue today or to their customers -- you know, to
4 any of their customers or counterparties.

5 So I think releasing a report to the
6 public would add considerable risk to the
7 consultancy report, and, you know, what the
8 standards are, and whether or not, you know, the
9 understanding of what you would have to spell out
10 in the report so that it's clear and what the
11 issues are.

12 MR. PALUMBO: I agree with Dan. And
13 back to what's been mentioned before, that
14 consulting report is given to the firm or the
15 company that hired us to produce and perform the
16 report. And others, if they're going to use it,
17 we can talk a little bit about this access letter.
18 There is some agreement that any other user of
19 those reports would have to sign and agree to. So
20 just to echo what Dan said, public distribution of
21 that is not within the AICPA standards of CS 100.

22 MS. BAGAN: But I think you also have to

1 keep in mind that it is the Joint Audit Committee
2 and not just the DSROs. The programs themselves
3 belong to the Joint Audit Committee, so there's
4 not just a management of a firm. There's, like,
5 20 firms involved here.

6 MR. PALUMBO: That brings up a good
7 point. Back to what we talked about before, who
8 is engaging? I know the way the rule is proposed,
9 but who is engaging the firm to perform the
10 reports, actually do the report? That is to be
11 discussed because that brings up -- there might be
12 multiple firms that are serving DSRO capacity.
13 That might have to be considered.

14 MR. PICCOLI: Right, and I think the
15 proposal, it's either the DSRO or the Joint Audit
16 Committee, if the direction of the DSROs is to do
17 it through a Joint Audit Committee, going through
18 that --

19 MR. MCISAAC: Yeah, if you're going
20 through the committee, then you're looking at the
21 program in total as opposed to looking at how it's
22 taken care of by the various firms. So it's a

1 different view if you're just going to go look at
2 the program, say, yeah, this program makes sense,
3 or you're looking to see how the CME, or the NFA,
4 or any of the other DSRs utilize that program and
5 work through it. And that's the testing part that
6 we usually go through is looking at how they
7 accomplish their controls, how they accomplish
8 their goals.

9 MR. PICCOLI: Yeah, and the good news
10 there is it's really just the CME and the NFA are
11 really the two that do the execution phase, but
12 the Joint Audit Committee does have -- you know,
13 the firms do have equal say in, you know, the
14 testing and what should be done and how it should
15 be done. But the execution phase is CME and NFA.

16 MR. TELZER: Kevin, one thing I would
17 point out is that, and I don't want to say I'm an
18 expert in this. But when you talk about the PCAOB
19 style review, that required significant enabling
20 regulation to have the part one and part two style
21 reports done. And indeed, I'd even say when the
22 DSRs carry out their exams of an FCM, those are

1 not publicly available unless they result in an
2 enforcement action, and even then, the only thing
3 in the public domain is the actual enforcement
4 result, not the actual report that resulted in the
5 enforcement.

6 So I think that's just something that
7 needs some thought process about what is it that
8 you want in the public domain, and then whether or
9 not, as Dan rightly said, from a risk management
10 perspective we'd be allowed to issue reports that
11 bifurcate between what's in the public domain and
12 what's not.

13 MR. PICCOLI: Yeah. No, thanks. I
14 think that's an excellent point that we have to be
15 sensitive to, and we'll have to look and see
16 whether or not Article 8 that we have would keep
17 this as confidential and not something that's
18 disclosed to the public, which we'd have to look
19 at. We think normally when anything has
20 proprietary or confidential firm information, that
21 that would be excluded. But we'd have to look. I
22 don't know, Tom, if you had any thoughts.

1 MR. SMITH: Yeah. I think that's
2 exactly right. We'd have to -- you know,
3 depending on what was ever made public in this
4 context, we'd certainly have to comply with the
5 statutory provision, Section 8, as to what could
6 be made public. So that would all have to be
7 looked at and figure out what it is that the
8 Commission -- first, if it decided to make
9 anything public, and then, two, what can it make
10 public.

11 MR. PICCOLI: Okay. I want to move on,
12 if we can, to sort of the standards to be measured
13 against. And I know there are a number of
14 different standards that are out there. You know,
15 the generally accepted auditing standards. PCAOB
16 has standards which, for the most part, encompass
17 all of GAAS into that. There are AICPA standards.
18 The Institute of Internal Auditors has their own
19 set of standards.

20 And while I think there isn't one set
21 that's just perfect for what we're looking for, I
22 guess the question is, is it something where we

1 can look and say, okay, you know, within PCAOB
2 there's these 10 standards that we would like
3 measured against, or, you know, maybe it's a mix
4 and match of, you know, the -- because the
5 Institute of Internal Audit has some outstanding
6 standards that they apply to internal audit groups
7 that may have some applicability to what we're
8 looking at here in terms of risk assessment and
9 the like.

10 Is that something, if we can just talk
11 about the types of standards that are out there
12 and, you know, how we can get that, because at the
13 end of the day, we need to measure against
14 something. And, you know, existing standards are
15 always a good way of doing the measurement. I can
16 open that up for discussion.

17 MR. PALUMBO: Yeah, Kevin, I think the
18 way you described it is appropriate. There are a
19 lot of standards out there, whether they be GAAS,
20 PCAOB, or internal audit standards, pieces of
21 which will probably be relevant for this. And I
22 think looking through those standards and thinking

1 about which ones do apply, whether it be in the
2 planning phase, the field work phase, or the
3 reporting phase, thinking about each of those and
4 saying is this something that applies to this
5 specific situation. And that I think needs to be
6 agreed to. The Commission needs to help us think
7 through which ones would you like us to be looking
8 at as well.

9 A findings and recommendation report
10 could contain an appendix that talks specifically
11 about these are some of the guidelines that we
12 used and some of the standards that we considered
13 as we went through the report. The better that's
14 defined, that will assist in the performing of
15 something that's useful to you and meets your
16 needs. So I do think that's a process worth going
17 through.

18 And I agree with you. There are pieces
19 of each of those different standards that you
20 references that are relevant to this, but it would
21 have to be carefully defined and gone through.

22 MS. BAGAN: Yeah, I agree with Joe. I

1 think the rule as it is proposed today is just too
2 vague. We're not sure which standards we're
3 supposed to be following. It's very generic, and
4 without that specificity, we would have no idea
5 which ones we're being held accountable for.

6 MR. TELZER: Yeah. I think both from
7 what Joe and Anne said, I'd like to just add is,
8 yes, the standards have pieces of applicability,
9 but I would offer that if you step back and look
10 at either PCAOB as it intersects with GAAS, those
11 are primarily financial reporting standards and
12 involve, if you will, the responsibility of a CPA
13 in how they conduct and perform their audit to
14 result in an opinion on a financial statement or
15 set of financial statements.

16 The IIA standards really deal with how
17 an internal audit function does a risk assessment,
18 how they conduct their examinations, whether or
19 not the reports that they issue contain all the
20 appropriate steps, and the findings, and
21 recommendations. And the AICPA, if you will, then
22 layers in, because they're the ones who issue GAAS

1 for private companies. They also issue the
2 attestation standards. They issue the consulting
3 standards.

4 So again, as Joe said, each of them has
5 elements. The risk is if you're not clear on what
6 the Commission really wants, you get a hash total
7 of adding up PCAOB and GAAS and AICPA, and you
8 wouldn't really ever get anything that's opinion
9 like. You would just get a report, I think we
10 talked about earlier, that may be more
11 consultative in nature. But again, does that
12 really serve the needs of what the Commission is
13 looking for, what the expectation is?

14 So there's not a pro or a con. It's
15 just there's no standard that exists right now I
16 think that neatly fits some of what is at least
17 proposed in 1.52.

18 MS. BAGAN: And I think it's really
19 important to keep in that what we do are not
20 audits. We're not commenting on the firm as a
21 whole or as a going concern. We are looking at
22 specific regulatory type of requirements. So to

1 hold us to GAAS or to PCAOB probably is not
2 appropriate because that's not what we're doing.

3 MR. PICCOLI: And I think that's a great
4 point, Anne, but I think at the same time, there
5 are standards that we need to make sure that are
6 being employed. And whether that's standards on
7 supervisor -- you know, how you supervise an
8 examination between -- on the competency of the
9 staff, work paper preparation, sampling
10 techniques, risk assessment techniques, you know,
11 training of staff, I mean, those are all, I think,
12 some great standards that are encompassed in the
13 PCAOB, AICPA, and so on.

14 But I think it is trying to pick out and
15 excluding certainly anything that's more financial
16 statement related because that is outside of our
17 scope going through. But we need something to be
18 able to say, you know, that, yes, we are measuring
19 ourselves against the standard. Here's the bar
20 that we're holding ourselves to.

21 MR. TELZER: Kevin, one thing that as
22 you think about 1.52 is, if the Commission wanted,

1 and the SROs agreed this was the right way to
2 approach it, you could take the elements out of
3 GAAS or PCAOB or IIA, or whatever. You could
4 embed those in the regulation, and then that
5 becomes the measurement stick that could be used,
6 because then you actually have a regulation that
7 says this is the expectation.

8 But that becomes very prescriptive, and
9 the danger in being prescriptive is you leave
10 something out that you really wanted, and you only
11 get the result that it was designed based on the
12 prescription. So with the proper thought, I could
13 see how this could work, but it would require 1.52
14 being much more detailed than it is right now.

15 MR. PICCOLI: Yeah, and we get there a
16 little, Sam, because we do talk about, you know,
17 here are certain standards. But I think that's a
18 valid point. Thank you.

19 MR. FLOWERS: Yeah. I think that -- I
20 was going to make the same recommendation Sam
21 talked about to make 1.52 a bit more descriptive
22 with respect to what the work should be. To the

1 extent that you're going to leave it up to a
2 consulting review, then it's going to be more a
3 discussion with you all to determine the actual
4 scope of the work. And that would be describe as
5 part of the consulting process.

6 But I think that the -- having a
7 measurement stick of the standards embedded in
8 1.52 may be appropriate in that it will capture
9 what you believe to be some of these certain
10 exposure areas. And it could be evaluation of
11 risk. It could be, you know, evaluation of the
12 training facilities that are provided, and all
13 kind of other specific items that you would expect
14 to be encompassed in the actual report.

15 MR. PALUMBO: And I think the Commission
16 does start doing that in 1.52. And whether or not
17 it's done in 1.52, that's probably an alternative.
18 Maybe it can be done in the RFP process, too, for
19 the proposal process. And that's just another
20 alternative, and I'm sure there's pros and cons to
21 that as well, but to give you room to change or to
22 expand as the Commission would like other topics

1 covered.

2 But just to echo what we've been saying,
3 I do think important to lay out more specifically
4 than what's currently provided what specific
5 standards are we comparing to, are we thinking
6 about in the performance of this report.

7 MS. THOELE: And just to echo a lot of
8 the comments, I mean, I think that, you know,
9 definitely 1.52 should spell out more on what the
10 standards are. But I also think we have to be
11 cognizant of the fact that the CPAs have a job to
12 do and we have a job to do, and they're two
13 different things. And where is there duplication,
14 and why should there be duplication, and the costs
15 involved, and all of those things that come into
16 play.

17 MR. PICCOLI: Yeah, I think that's a
18 great point, Regina, because there are, you know,
19 elements. The CPA has definitive responsibilities
20 that we look for in the overall oversight program.
21 And then the DSROs have other critical elements of
22 the oversight program, so making sure that we

1 blend those in properly I think is a very good
2 observation.

3 MS. VOGEL: I'll just make one comment.
4 I think as part of the risk assessment, we as a
5 regulator need to understand the segregation of
6 duties at the firm as well as the competency of
7 the accounting firm that's performing the review.
8 And we take that into account in determining how
9 much to rely upon the independent accountant's
10 work, or to determine, you know, whether or not we
11 need to do our own re-review of areas that the
12 accountant may have conducted.

13 MR. PICCOLI: Yeah, I think that's a
14 good point because, you know, looking at the
15 accounting firm itself, not all are at the caliber
16 of some of the folks in this room in considering
17 that in the risk assessment of the firm and, you
18 know, how much reliance can we place on a -- you
19 know, for example, a one person accounting firm.
20 They're not going to have the same level of
21 quality controls that a big four firm would have
22 or a middle tier firm would have that we would

1 like to see. And that would definitely impact the
2 risk that the DSRO has when they're doing their
3 exam, and in looking at the design their audit
4 plan and scope.

5 MS. VOGEL: So it sounds to me that
6 there are two pieces to the review that you're
7 looking for. One is a review of the procedures
8 and components of the Joint Audit Program, and
9 then a second review of how each DSRO is carrying
10 out that program. Am I correct in the way I'm
11 thinking about it?

12 MR. BARNETT: Yes.

13 MR. FLOWERS: But I think that the level
14 of internal controls, and the fact internal
15 controls are working, and your assessment of those
16 internal controls to the extent that they're
17 fundamental controls, are they monitoring
18 controls, and to what extent are they going to be
19 given credit, so to speak, to reduce the risk
20 associated with the particular function you're
21 evaluating.

22 I think that the quality of those

1 internal controls should be part of the process,
2 and that, you know, particularly with regards to
3 the PCAOB has been, you know, harping on us to
4 make sure that we've got the -- our internal
5 controls have done the right thing, and we've
6 tested them correctly, and made a proper
7 assessment of them. And I think that's endemic on
8 all auditors to follow those procedures.

9 I think specifically with regards to the
10 Berkeley Research Group, they indicated, well,
11 there was a concentration of certain individuals
12 who controlled the firm, that that would be a
13 clear violation or raise awareness as to, you
14 know, you have to change your audit procedures to
15 take into account the risks associated with that
16 concentration of personnel in a certain area.

17 I think that particularly with regards
18 to some of the controls, they may have been more
19 fundamental controls, but if you were going to
20 rely upon monitoring controls, which we have a
21 broader basis, we need a basis for permitting you
22 to utilize monitoring controls. And that's

1 something that the PCAOB has actually held up
2 quite admirably, I'll say, because we all like to
3 love PCAOB. But that's been one of the areas that
4 they've been adamant about.

5 MR. PICCOLI: Dan, I know you had --

6 MR. MCISAAC: Yeah. I mean, I think
7 also as you go through the firm, like Grace said,
8 their assessment, when you go in and look at their
9 assessment of what they've done, firms will have
10 to, you know, recuse themselves from looking at
11 certain firms. There's a confidentiality issue
12 there that might be a problem for firms to look
13 at. I certainly wouldn't be able to go into CME
14 and look at one of my firms that they did because
15 I'd be biased in some respects. But also there
16 were things I would know that, you know, that they
17 may not know or vice versa. So that has to be
18 very careful on how you do that.

19 And I think it's also, you know, you
20 really would have to understand, you know, what
21 they're doing with the firms and understand the
22 firms more to really, you know, determine if their

1 assessment was done properly.

2 MS. BAGAN: And I just want to point
3 out, too, that we do look at internal controls
4 when we are planning our audits. We use that as
5 an assessment of what type of scope we need to
6 have. So we are looking at separation of duties
7 or whatever. That's all part of the planning
8 before we even walk in the door. We're asking
9 these questions and finding out, you know, have
10 there been management changes or whatever, or who
11 does what, what kind of controls are in place.

12 So I don't want anybody to think that
13 we're not doing that today because that is a
14 critical part of how we determine what needs to be
15 reviewed on our examinations.

16 MR. TELZER: And, Anne, I just want to
17 add, though, having read the report that was
18 issued last week by the Berkeley Group, there are
19 some themes that are in there -- the standards
20 that a CPA follows would really talk about, and
21 some of those things include the training of
22 people to make sure they have an adequate level of

1 knowledge about what they do -- the review and
2 supervision, the way issues are identified and
3 bubbled up.

4 So there's one part which is what's the
5 control environment of the enterprise that's
6 actually doing something? The second piece is
7 that the people at the organization, whether it be
8 the CPA firm or the DSRO, is how they carry out
9 their responsibilities because the PCAOB and GAAS
10 both have a lot of requirements about how an
11 auditor is to discharge their responsibility.

12 And what I haven't really heard from
13 either the rules or any of the discussion yet is,
14 we talk about, if you will, the front part, which
15 is how do you know if the entity that's being
16 examined has a control structure, has management,
17 has process? The second part is the people doing
18 the examination need to have a level of competency
19 and need to have -- there needs to be a level of
20 review and supervision to address this. And that
21 right now is not captured in anything in 1.52. It
22 is embodied within the requirements of GAAS or

1 PCAOB. So I'm wondering if you could maybe give
2 us some guidance on what those expectations are.

3 MS. BAGAN: Well, that's something that
4 your staff comes in and looks at with us, what
5 kind of training we have, and what level of
6 expertise, and how long people have been in the
7 department, and, you know, whether they have a
8 CPA, whatever. So that is something that the CFTC
9 does look at the DSROs.

10 MR. TELZER: And, Anne, I'm just asking,
11 though, if there is a report that the CFTC wants,
12 how do those areas get encompassed because those
13 are, again, very embedded within the professional
14 standards that the PCAOB or GAAS has. And
15 everything we've talked about has more been about
16 the entity that's being examined as opposed to the
17 examining authority itself.

18 MR. BARNETT: And I don't know how off
19 target I'm going here or how far off topic. But
20 FINRA's annual regulatory and examination
21 priorities letter recently came out, and in it
22 FINRA discussed, you know, the risk orientation

1 and the control focused examination. It was
2 referred to in the letter. It was a short letter,
3 so I just, you know, that orientation, which we
4 need to bring more into our orbit as well.

5 How does what you're doing relate to the
6 topics we're -- relate to this point that we're
7 hearing about, trying to provide more specificity
8 on standards? I mean, what standards are you guys
9 referring to, or discussing, or applying in terms
10 of when you're telling people we want to see more
11 risk orientation and control-based platform?

12 MS. VOGEL: I think the annual
13 examinations letter is meant to give a head's up
14 to the FINRA member firms as to where we will be
15 focusing our efforts in the coming year so that
16 firms can prepare for our examinations. And if
17 there are areas of control weaknesses or problems,
18 to the extent that they can correct those problems
19 before we get there, that would be a good thing
20 for everyone.

21 From the standpoint of our risk-based
22 examinations, we are receiving and will continue

1 to receive a lot more data ahead of time so that
2 through -- in an automated fashion, so that tests
3 that we used to do manually by just, you know,
4 flipping pages of a stock record and looking at
5 every 30th item, we now have automated feeds
6 coming in for the largest firms, and we're able to
7 produce exception reports that identify samples
8 for testing, so that when we go out into the field
9 and we actually do our examinations, the tests
10 will very often reveal the problems because the
11 samples are a lot smarter.

12 We also have extensive planning that's
13 done prior to each examination. Our program is
14 set up so that each firm has a coordinator
15 surveillance person who has the continuous contact
16 with the firm throughout the year and ongoing
17 monitoring of the various financial reports, and
18 has ongoing conversations with the firm. They
19 have an understanding of the firm's, you know,
20 prior history, prior examination findings. And
21 that coordinator is instrumental in working with
22 the examiners and planning the scope of each

1 examination.

2 You know, the examinations, there are so
3 many areas to review at this point in time, and we
4 can't possibly look at everything. So when we say
5 "risk based," it's really risk informed to a large
6 extent. So based upon the coordinator's knowledge
7 and all the information that we have to review
8 ahead of time, we are making a determination as to
9 which areas to review when we're actually in the
10 field.

11 MR. BARNETT: All right. And in terms
12 of your -- when you look at the adequacy of
13 controls, is there a standard, or am I connecting
14 -- are the comments I'm getting from the
15 participants go to the oversight of the
16 examination process when you're saying you want
17 more standards, or are you -- would you be
18 referring to the things, say, for instance, what
19 standard does FINRA apply when they go to look at
20 -- test the adequacy of controls. Do you
21 understand what I'm asking?

22 MS. VOGEL: I think there may be two

1 questions, right? So the examiners will review
2 adequacy of controls of the firm. I think what
3 you may be getting at the supervision process at
4 FINRA to make sure that the examiners are
5 appropriately discharging their responsibilities.

6 So for the examinations of carrying and
7 clearing firms, there are two levels of
8 supervisory review. There's an experienced
9 examiner in the field, a manager in the field
10 who's responsible for the review process. And
11 then there's an examination director who is in the
12 field and, you know, in the office conducting that
13 second level of supervisory review.

14 MS. BAGAN: And we have that same thing
15 at CME. And in addition, all of our examinations
16 go through what we call a consistency review where
17 one person looks at every single exam that goes
18 through and make sure that everybody's treating
19 similar items consistently. So every single one
20 of ours is a quality review, if you will.

21 MR. PICCOLI: Okay. Just another topic,
22 and I think we touched on this very briefly, but

1 I'd like to spend just a little bit more time so
2 we can get a little more insight into it. And
3 that's new and best practices. And, you know,
4 it's certainly something that, you know, we all
5 need to make sure that we are constantly thinking
6 of best practices, lessons learned, and building
7 that into the program.

8 How is that a concept that we could
9 build into this expert exam report? And is it
10 something that we can build into the report? You
11 know, do we just leave it out there saying and
12 please comment on, you know, whether or not the
13 program met best practices or, you know, is
14 considering current industry issues.

15 MR. TELZER: I'll offer just this view
16 is that there's no standard I'm aware of that I
17 practice under that says comment on best practices
18 as a CPA. So I think the first question I would
19 ask is, who is best practice? What is best
20 practice, because again you need a definition of
21 my best practice may not be the same as what
22 Michael's or Regina's best practice is.

1 So I think the thing is you could ask
2 for anything you want. Whether or not we could
3 deliver it is a different issue in any form.
4 Typically, because I'll give you this as a thought
5 process. Typically when a client engages us to
6 look at a process, we do it under -- and I think
7 Joe talked about the consulting standard -- you
8 will typically say here are known industry
9 practices of the way things occur. And you can
10 usually draw citations out of things that have
11 been published in the public domain, and then use
12 that as a reference point to give somebody some
13 thought process about what they're doing versus
14 what other industry participants are doing.

15 If that's what you're aiming for, then
16 try and define it that way, and then we have a
17 measurement yardstick to use.

18 MR. PICCOLI: Let me phrase it
19 differently then, Sam. I know when I was in
20 private -- in getting all the RFPs, you know, all
21 of the firms talked about how they know best
22 practices, and they have the experts, and they can

1 tell you exactly where -- you know, what you're
2 doing. And if we compare it to best practices,
3 how do we get -- you know, what normally comes out
4 of an RFP where the firms are touting their
5 expertise, how do we get that into something where
6 we say, okay, now take that expertise that you all
7 have and give us an assessment on how the program
8 matches with your level of expertise.

9 MR. PALUMBO: You could -- I think some
10 of what we were discussing, I agree with all of
11 it. You could, though -- industry practice.
12 There are industry practices. Whether that ties
13 back to a specific standard or whether that ties
14 back to some published material, as Sam mentions,
15 that's okay. We could do that. But there are
16 accepted industry practices as well that I think
17 as you worked through the report, there was an
18 area that we came up with a finding for what
19 supports that finding. What would be the reason
20 for that? And if that is an industry standard, I
21 think most would agree what an industry practice
22 would be.

1 But I agree with Sam. That concept of
2 best practice is hard to define. It's something
3 that many different people would have a different
4 view on. But there are industry practices that I
5 think most of us will agree in areas, whether it
6 be accounts payable or whether it be another
7 topic, there are industry practices that have been
8 around for quite some time that we would agree if
9 they were not in place would be a finding and
10 could be compared to what we would say would be an
11 industry practice.

12 MR. JAMROZ: I think we need to be a
13 little more disciplined in our discussion about
14 who we're talking about because I think, strictly
15 speaking, the way that this has been proposed, the
16 practices that would be the best, you know, that
17 we would be looking for are the examination
18 practices of the SROs, of which I'm told two do
19 the exam. So the two of them presumably can talk
20 amongst each other and determine what the best is.

21 I mean, I think it's important, too,
22 because we're kind of jumping to what is the best

1 practice of the underlying entity being examined,
2 which there are many, and I'm sure that people in
3 this room can discuss the rest of the day what
4 best practices those are to any related to
5 subject. But I think here we're really talking
6 about examination practices.

7 Now we -- I think there's a role to play
8 for firms like ourselves because we do something
9 that's similar, but not the same. They're doing
10 examinations. We do either test examinations or
11 we do consulting jobs. But either exercise has
12 some similar attributes. So we can say things and
13 give folks who do something similar advice as to
14 what we think works or doesn't work, but I don't
15 think what you're looking for -- something there,
16 some kind of thing where it precisely tells you
17 what the best practices are, what the ideal
18 standards are, exist. I think there are things
19 out there that you can look to, and I think to
20 some extent, the auditing standards that you
21 listed have elements of best practices in them.
22 So if there's any one place to look, I think

1 that's a good starting point among others, but I
2 don't know that there's anything -- any magic
3 bullet here.

4 MR. PICCOLI: Yeah, I think that's fair,
5 Mike, thank you. But I do think -- I wouldn't
6 limit to DSROs in terms of best practices because
7 a lot of what we're talking about, like planning
8 and examination, risk assessment, you know. I
9 think it goes beyond just DSROs and that point,
10 but you raise a very valid observation.

11 MR. FLOWERS: I think the extent, for
12 example, of data analytics, the extent that the
13 actual audit practices themselves do a lot of data
14 analytics, and utilization of that information,
15 and how does that adjust, how do you examination
16 procedures change, because you analyze the data in
17 a certain methodology. There could be some
18 improvements on that relative to just the amount
19 of data that we now have to get examined,
20 particularly, say, if we wanted to identify some
21 of the issues related to high frequency trading or
22 anything that has a significant amount of data

1 associated with it that should be evaluated. And
2 the way in which we go about determining
3 information, out of that data, I think is
4 important.

5 MR. PICCOLI: Okay. Thanks, Rich.

6 MS. VOGEL: I'd like to just make one
7 comment. I think we need to be cautious about
8 coming up with a program that's very prescriptive
9 and check the box like, because we need our
10 examiners to think. They need to, you know,
11 assess the risk and keep turning over every stone.
12 And if they're focused on answering lots of very
13 prescriptive questions, then they may miss the
14 next problem.

15 MR. PICCOLI: You're absolutely right.
16 We don't want a tick and tie mentality. That's
17 just -- yeah, they're going to miss the boat.

18 Okay. Why don't we move on to
19 qualifications? What would be the qualifications
20 that we should look for in an exam expert. I'll
21 throw that open to the group. What would you
22 expect to see or recommend for qualifications?

1 MR. MCISAAC: I guess there's two phases
2 of qualifications. One, the firm itself and does
3 it do similar type exams and know how to risk
4 manage? And the other part would be also do they
5 understand the industry I guess. So there's two
6 parts of what an expert can do.

7 An expert can come in and say whether or
8 not you're doing the right training and things
9 like that, you don't have to really understand the
10 industry to understand that. But then you have to
11 get deeper down whether or not the firms that
12 would be considered experts have the expertise in
13 the business to determine whether or not DSROs are
14 looking at the proper -- they're looking at the
15 things that we would look at or what we would
16 think would be a risk. So there's two levels of
17 risk there, so I think you got a -- I think you
18 want -- further down you want somebody who does
19 the work, understands the risk, but also
20 understands the business.

21 MR. FLOWERS: I think you should
22 strongly consider some of the reports by the PCAOB

1 relative to the examination of the audit firms.
2 And to the extent that they have cited that
3 certain audit firms have done their assessment
4 process more accurately, or have fewer potential
5 issues, I think it's an important area. I think
6 they're the ones that, you know, forget the
7 industry. They're looking at the real audit
8 procedures themselves. To the extent that you
9 actually implement those audit procedures
10 adequately, I think that's the important aspect of
11 this.

12 MR. TELZER: The thing I would offer on
13 examinations expert is, when you talk about
14 qualifications, I guess the first question I have
15 is, what do you expect -- what do you want from
16 that expertise? In other words, do you want the
17 firm and the person to be a CPA, or is that not
18 relevant for this purpose, because there are a lot
19 of people who understand an FCM in the futures
20 business that are not accountants and are not
21 CPAs. Some are lawyers. Some are operations
22 people. So there's a wide swath of who's an

1 expert and what does an expert mean.

2 Within the CPA framework, as we talked
3 about earlier, there are standards under which a
4 CPA has to operate, which encompass quality and
5 training, and if you're subject to PCAOB review,
6 what the PCAOB says about your firm. And then you
7 start getting into some of what I think Dan, and
8 Rich, and Joe talked about is the expertise of the
9 industry, because obviously there are nuances
10 within the industry, understanding how a DSRO
11 operates, understanding the regulations,
12 understanding how an FCM operates.

13 So I think when you define "examinations
14 expert," part of what you need to start with is
15 that what type of organization do you want to be
16 doing that examination, because if you say "CPA,"
17 that has a particular meaning. If you say
18 "legal," that has a particular meaning. And if
19 you don't define it, in the absence of that
20 definition it actually has a meaning.

21 So I just say that -- I'm not saying be
22 prescriptive. I'm just saying the exam expert

1 needs to have an appropriate definition to it so
2 that someone could meet it and not be so
3 prescriptive that it's impossible to find someone
4 to do the work.

5 MR. STEVENSON: And if I could just come
6 back to something I think Rich was saying. And I
7 should say, first of all, as with you, my comments
8 here don't represent necessarily the views of the
9 PCAOB or board members or staff there. But I
10 would just suggest that you be cautious about the
11 extent to which you go down a road of interpreting
12 publicly available PCAOB information about firms
13 as sort of providing much of an indication on this
14 question. Because of the way the law limits what
15 we can make public, there are some limitations, I
16 think, that would be important for this purpose.
17 Just how far you go in relying on or interpreting
18 that to identify someone as qualified or not for
19 the kind of work you're talking about.

20 MR. PICCOLI: Okay.

21 MR. SMITH: Are we just mostly done with
22 your question, Kevin, on examination reports at

1 this point? I just have, like, a little different
2 angle to go down, if that's okay with you.

3 MR. PICCOLI: Sure.

4 MR. SMITH: This is also part of the
5 proposal that I just wanted to get some feedback
6 from this group here, and particularly, I think,
7 Grace, you might've gone through this already.

8 As part of the proposed rulemaking, with
9 respect to the certified annual report, the
10 Commission is proposing that the public
11 accountants be PCAOB registered and also subject
12 to at least one examination, and have taken steps
13 to address any sort of deficiencies or
14 recommendations made as part of that review.

15 I think from the analysis we have done,
16 this is not a significant issue just looking at
17 the total number of FCM registrants that we
18 believe already do have PCAOB registered firms,
19 but there will be some that aren't. And I assume,
20 Grace, when this came through, this was an issue
21 like FINRA and the SEC when this became
22 applicable. But looking at that, you know, ours

1 is not a requirement. Ours is a -- this
2 Commission has taken the action. In your case, it
3 was a different -- it was a statute.

4 But, one, how did the transition go? Do
5 you have any thoughts for the Commission on that?
6 And also the technical aspects of our rule, which
7 require examination and require the response of
8 the firm to those reports. I was just wondering
9 if anyone had any thoughts on that.

10 MS. VOGEL: After a lot of moaning and
11 whining from the membership about the increased
12 cost of having an audit performed, everyone did
13 comply. I think what we see as more important is
14 familiarity with the industry. So an accounting
15 firm that has a number of broker-dealer clients
16 generally has more expertise.

17 So we flag when we do our examination
18 planning a broker-dealer that has -- that use an
19 account and auditing firm for which they're the
20 only broker-dealer client. That's a red flag for
21 us. Or if there's a small number of broker-dealer
22 clients, that's a red flag.

1 MR. SMITH: And in the proposal, the
2 Commission is putting an obligation on the FCM
3 management in selecting the public accountant to
4 look at such issues as, you know, how familiar is
5 that CPA, even if it is PCAOB registered, with the
6 FCM world and the Commission's accounting
7 requirements. Do they have other FCM clients? I
8 think that's part of it.

9 But some of the comments we received to
10 date are talking about -- you know, potentially
11 excluding, you know, some area of accounting
12 professionals that would be competent to engage in
13 these reviews. But, I mean, our objective is
14 we're looking for something more than the
15 traditional peer review process. We want the
16 PCAOB sort of oversight of these entities.

17 MR. STEVENSON: And as you said, I
18 think, you know, one of the differences between
19 what you proposed and what happened with the
20 auditors of broker-dealers is that the auditors of
21 broker-dealers were only required to be registered
22 with the PCAOB. And you've proposed that they

1 also have been inspected by the PCAOB.

2 We do a lot of inspections of auditors
3 that have issuer audit clients. And the results
4 -- big pieces of the results are those inspections
5 are not public, as we've talked about.

6 I think you want to be thoughtful about
7 how readily the fact that someone has an
8 engagement to audit an issuer translates into --
9 just because we've inspected them translates into
10 some heightened qualification to do work on FCMs.

11 MR. SMITH: Right. I assume as part of
12 your assessment of what to look at at these
13 organizations, you have your statutory
14 responsibilities as broker-dealers and auditors of
15 issuers and not necessarily -- if they also engage
16 in other types of firms, such as an FCM, that's
17 not a, what I'll call, a high priority. It's not
18 your mandate.

19 MR. STEVENSON: That's right.

20 MR. FLOWERS: I think the big issue, or
21 relatively big issue, related to the PCAOB is the
22 extent of independence requirements for the

1 auditing firm. For example, you know, our
2 inability to do certain areas of work because it's
3 prohibited. Certainly there are certain
4 structural requirements because of a requirement
5 for a -- it used to be called a second partner,
6 but in the engagement quality review that performs
7 that task.

8 Certainly the depth of the firm is put
9 into question if they don't have adequate
10 resources to be able to meet the rotation
11 requirements, which are, you know, required under
12 the PCAOB rules. It's certainly more restrictive
13 than the SEC requirements. So there are some
14 added structural problems that have been placed
15 before us because of PCAOB registration. I think
16 that the -- that applies to doing the work. I
17 think the actual evaluation of the quality of the
18 work and the procedures that the accounting firms
19 actually perform are certainly more onerous now
20 than the PCAOB actual review.

21 And I think that that has stepped up our
22 ability to evaluate general controls and the way

1 in which we go about documenting our assessment of
2 the internal controls. And the fact it's not
3 documented, it's considered not done. So our
4 level of documentation has significantly increased
5 on a required basis because of PCAOB. So you
6 could translate that into your assessment, using
7 the PCAOB standards.

8 MR. PICCOLI: And, Rich, is that -- the
9 improvements and your responsiveness to PCAOB, is
10 that because of the review or just because of the
11 potential. You hear they're looking at this or
12 we'd better make sure we've got this button down,
13 because I'm sensitive to the fact that Michael
14 raised that, you know, not every firm is reviewed.
15 So is it just the possibility that causes a firm
16 to make sure that they do have the right quality
17 assurance in place?

18 MR. FLOWERS: Oh. We obviously just
19 wanted to comply with the standard GAAS.

20 MR. TELZER: Tom, maybe I can offer
21 something just as a thought process when you look
22 at the competency of the firm doing an FCM exam.

1 There are a least two, maybe three, flavors of
2 FCM. There's an IB, there's an FCM, and then
3 there's a retail FOREX dealer. And I think each
4 one has its own quirks, if you will. And when you
5 define, if you're going to, what a CPA firm needs
6 to know about an entity, we could have 100 IBs.
7 That doesn't mean we know how a full clearing FCM
8 works. And you could do 20 retail foreign
9 currency dealers. That doesn't mean you know how
10 an IB works.

11 And I think when you draw the net wide,
12 it's fine. But you may get a result that you
13 don't like if you draw the net too wide in terms
14 of how you define "expertise."

15 MR. SMITH: Thank you.

16 MR. BARNETT: Other -- I think we've
17 exhausted our questions. Are there things we've
18 failed to elicit that panelists want to offer up
19 before we close the session?

20 MR. FLOWERS: I think that we should be
21 cognizant of the fact that particularly dual
22 registered firms, to the extent that examination

1 be performed by -- under the Joint Audit
2 Commission, have, in fact, the issues related to
3 the side of the firm that actually is under
4 supervision by FINRA have the risks associated
5 with that firm and the execution of the
6 examination under the JAC determined rules, that
7 they incorporate the activities of the
8 broker-dealer, because I think that -- certainly
9 to the extent that, you know, the JAC determine
10 procedures, oftentimes start with -- we have the
11 futures accounts, and let's balance the futures
12 accounts, but we'll take care of the securities
13 accounts differently.

14 But I think that the reality is in terms
15 of risk is you need to see both of them together
16 to actually assess the firm to see whether there's
17 any potential fraudulent activity or other
18 transactions that are happening across those
19 entities. And I don't think we should be
20 isolating work just on the FCM solely.

21 And I believe there's a lot more than
22 just, you know, the MF Global issue.

1 MR. BARNETT: Right. Thanks, Rich.

2 MR. MCISAAC: Yeah. I think that brings
3 in a certain issue for you because I'm sure that
4 CME and the NFA do consult with FINRA from time to
5 time, and how far can the expert review those
6 consultations because now you're encroaching with
7 something that FINRA may be involved in or may be.
8 So, you know, I don't know if the rules still
9 affect them or how they encompass them, but that
10 has to go into part of the whole concept of what
11 they're from a risk management standpoint.

12 MR. JAMROZ: To be honest with you in
13 thinking through the proposal, it seemed to me --
14 my initial reaction, which I still have, is that
15 to require any kind of exercise like this every
16 two years across the board seems to be, in my
17 view, excessive.

18 Now that's not to say we can't add
19 value. In fact, in the securities industry, we,
20 our firms, are asked by the people like FINRA or
21 the SEC to do consultant type reviews. They
22 usually emanate out of an incident or an exam or

1 both, where we design the consultant review around
2 what the client and its regulator wants. And, in
3 fact, I think others, our firm included, have done
4 similar reviews of SROs exam programs at the
5 behest of their regulator.

6 So my reaction is that it's the kind of
7 thing that, certainly given the few number of
8 organizations involved, could be worked out as
9 needed on a case-by-case basis rather than
10 required, you know, every other year on a
11 comprehensive basis.

12 MR. PICCOLI: So doing maybe one up
13 front and from there --

14 MR. JAMROZ: No, doing it when you think
15 it's needed.

16 MR. PICCOLI: Right. And then from
17 there going on a specific basis.

18 MR. JAMROZ: It just seems to be --
19 because going back to Sam's point --

20 MR. BARNETT: So, Mike, let me just --
21 I'm sorry, I should listen. So the futures space
22 fell away, did not do -- move towards risk and

1 control orientation the way the securities side
2 did four or five years ago.

3 So to just design some review for design
4 around what the JAC and the regulator want may not
5 get you to update and to take into account
6 practices and improvements that may be needed. I
7 mean, I think that that -- part of the periodic
8 review is intended to accomplish that.

9 The idea that -- when we talked about
10 best practices and we referred to industry
11 practices, I was struggling with the idea that
12 industry practice, if that just meant a space that
13 had -- maybe was too insular and hadn't taken into
14 account what was going on elsewhere, was not going
15 to get you to the right place. So maybe that goes
16 to looking outside the space to other things and
17 other ideas to be able to keep up and to change
18 oneself when one needs to, just as the futures
19 industry struggles right now.

20 So I don't know. I guess that's my
21 reaction to what you're saying. I mean, it just
22 seems to me that you end up grading yourself on

1 where you are. How would you react to that?

2 MR. JAMROZ: Well, going back to Sam's
3 point about the different qualifications around
4 the advisors in the futures industry, and also
5 going back to what I believe -- seeing some of the
6 comment letters is commentary involving the lack
7 of specific standards to which we would do this
8 exercise against, it seemed to me that doing or
9 asking for these exams on a more specific
10 case-by-case basis gets you closer to where you
11 want because we can agree to in our engagement
12 letter to do specific things in specific areas.

13 For example, the purpose of this
14 roundtable involves custody. Your rules, I
15 understand, as proposed would -- we would be
16 looking not only over the SROs supervisory program
17 over custody, but things like sales practices and
18 other things that are really kind of a different
19 set of skills and backgrounds. Different people
20 in our firm would think about and do sales
21 practice type engagements than those that do
22 custody.

1 So you're talking about a different
2 background and expertise, and a different set of
3 kind of procedures, things that we would do or
4 think about. So it just seems to me that it's the
5 kind of thing that, you know, where we can bring
6 value, but it's probably better done on a more
7 selective case-by-case basis, and then
8 comprehensively across the board every two years.

9 MR. BARNETT: Okay, thanks. Other
10 thoughts before we close?

11 MS. THOELE: One proposal that we -- the
12 CME and us have talked about is, you know, we meet
13 several times a year, the Joint Audit Commission,
14 with the CFTC. And we would like to look towards,
15 you know, involving the CPA community or the
16 auditing community to join in on those meetings,
17 maybe not for the whole time -- you know, the
18 whole meeting, but to talk about standards and
19 issues in the industry that we could then bounce
20 off of each other as part of a process towards
21 this.

22 So I think we would welcome that if

1 there's other ways for us to join in. We're on a
2 lot of different AICPA committees. If there's
3 other committees, we would love to embrace that
4 and join where we can add value, and likewise, we
5 would welcome the value that we think bringing the
6 CPAs to our meetings could bring.

7 MS. VOGEL: I wanted to make two
8 comments on risk-based exams. The first is that
9 the CFTC will have to get comfortable that certain
10 things will not be looked at. You know, we
11 started the process probably eight years ago with
12 the SEC, going through the dialogue of, you know,
13 these are the kinds of things we have historically
14 looked at. In the future, we're not going to look
15 at, for example, NSCC reconciliations or
16 settlements because if there's a problem, we're
17 going to hear about it from the street. But we
18 went through the litany of things that we were not
19 going to look at unless we saw a problem.

20 It also takes time to turn the ship when
21 you have a large number of examiners because
22 you're taking them out of their comfort zone now

1 that they're thinking risk based and they're not
2 following a very detailed program. So that
3 doesn't happen overnight.

4 MR. PICCOLI: Yeah, very valid. Thanks,
5 Grace.

6 MR. BARNETT: Thank you. Okay. Then
7 thank you very much, and we'll conclude this
8 session. And we will start again at 11:15 I
9 think, right?

10 MR. PICCOLI: Very good. Thank you.

11 (Recess)

12 Second Session - Proposed Enhanced Firm Specific
13 Disclosures and Financial Reporting

14 MR. BARNETT: Okay. We're going to get
15 started. Welcome back to the roundtable on
16 certain of the topics that were included in our
17 customer protection proposed rulemaking. So we're
18 going to move now into the second topic looking at
19 the proposed additional reporting and firm
20 disclosure. And we're going to -- this session
21 will end at the latest at 12:45 when we break for
22 lunch.

1 And just a reminder again, the
2 disclaimer that, you know, in the discussions,
3 individual staff makes express views and thoughts
4 on various topics. That person's view and
5 thoughts are those of that individual, not those
6 of the Commission, any of the commissioners, any
7 division, or any other staff.

8 So let's get our second session started,
9 and we thank the panelists very much for being
10 here. Let's quickly go around the table, each
11 person stating name and affiliation. And we'll
12 start with Alessandro.

13 MR. COCCO: Thank you, Gary. Alessandro
14 Cocco from JP Morgan.

15 MR. FILLER: Ronald Filler, New York Law
16 School.

17 MR. GREENBERGER: Michael Greenberger,
18 University of Maryland Law School.

19 MR. HOLLOWAY: Mark Holloway, Goldman
20 Sachs.

21 MR. HORGAN: Rich Horgan, Rosenthal
22 Collins Group.

1 MR. WOLF: Doug Wolf, National Pork
2 Producers Council.

3 MR. TIRRELL: Bill Tirrell, Bank of
4 America and Merrill Lynch.

5 MR. THUM: Bill Thum, Vanguard.

6 MS. VOGEL: Grace Vogel, Financial
7 Industry Regulatory Authority.

8 MR. SEXTON: Tom Sexton, National
9 Futures Association.

10 MR. KOUTOULES: James Koutoules,
11 Commodity Customer Coalition.

12 MR. KEMP: Todd Kemp, National Grain and
13 Feed Association.

14 MR. NUNERY: I'm Cam Nunery, Office of
15 the Chief Economist at the CFTC.

16 MR. SMITH: Tom Smith with the Division
17 of Swap Dealer and Intermediary Oversight.

18 MR. BARNETT: Gary Barnett, Division of
19 Swap Dealer and Intermediary Oversight.

20 MR. PICCOLI: And Kevin Piccoli,
21 Division of Swap Dealer and Intermediary
22 Oversight.

1 MR. BARNETT: Okay. And we should say
2 "DSIO" from now on. It's too long, you know?

3 Okay. So to start off the discussion,
4 we're going to look at proposed additional
5 reporting and disclosure. We thought the best way
6 to do that is Kevin is going to walk us through
7 our existing reporting regime and then give a
8 quick overview of the additional reporting
9 requirements. And so I'll turn it over to Kevin
10 to start that discussion.

11 MR. PICCOLI: Okay. Thanks, Gary. So
12 I'll go through here's what our current
13 requirements are. Just sort of starting off with
14 reporting requirements, financial reporting on a
15 monthly basis. We have the 1-FR, the focus
16 report. Quarterly, for any public firms will get
17 the 10-Qs and the risk assessment forms for anyone
18 that has to file under 17-H.

19 On an annual basis we will get the Form
20 10-K or F-1 from a public company. The risk
21 assessment from those who have to file under 17-H,
22 the certified audited financial statements and the

1 supplemental schedules, as well the letter of
2 internal control or material inadequacy letter
3 from the accounting firms. So that's the
4 reporting.

5 In terms of notices that we received, on
6 the capital -- and I'd break this down starting
7 with capital first. So the notices that we
8 received for capital on a pre-event notice level,
9 there's really just two that we receive. If an
10 FCM has a reduction in excess of 30 percent or
11 more, they need to pre-notify us -- if they're
12 going to do a dividend, we have to get a
13 notification -- or changes to sub-debt.

14 On a post-event, again just for capital
15 it's going to be under capital. They're under the
16 early warning requirements. Margin call exceeds
17 net capital or excess net capital, a reduction in
18 net capital of 20 percent or greater. And I think
19 there are a couple of others that get into
20 different derivations of that in terms of
21 percentage of decrease of capital or excess net
22 capital.

1 On the notices again for reporting, so
2 things that are reporting in nature that they have
3 to tell us on a pre-event notice, if the FCM is
4 going to transfer or liquidate customer accounts
5 at the initiation of the FCM, they'll have to
6 notify us ahead of time. Change in fiscal year,
7 and extension to file audited or unaudited
8 statements would be a pre-event notification. And
9 post-event notification would be failure to
10 maintain books and records, a material inadequacy
11 and internal controls, replacement of your CPA,
12 failure to pre-approve a transfer. An SRO notice
13 of a failure or a deficiency would come to us
14 after the fact. A notice that the SRO has
15 indicated that the firm is no longer a member in
16 good standing would come to us after the fact.

17 So the reporting -- just on the customer
18 fund side, customer funds being obviously seg and
19 secured, on the pre-event notification, we have
20 none, so there's nothing pre. On a post-event, if
21 the firm is under seg or under secured, they have
22 to notify us, or under their RFED obligations they

1 would have to notify us after the event happened.

2 And then just touching on public
3 disclosures that are out there. We have the CFTC
4 website which has segregation data, secured,
5 capital, and RFED obligations are there and posted
6 every month. But usually around the 20th of the
7 following month is when they get posted up there.
8 Public disclosure is obviously the customer
9 account agreement that the customer signed would
10 be a public disclosure. And then there is a risk
11 disclosure statement pursuant to 1.55.

12 I think all of these really focusing in
13 on what we're getting on a pre-event notice is, as
14 you can tell, a little bit limiting. And we get a
15 lot after the fact, so after the event happened
16 they'll tell us, you know, we're under seg, we're
17 under cap.

18 So some of our proposed reporting
19 requirements that we're asking for, on a daily
20 basis for daily seg, daily secured sequestered, as
21 well as on a bi-weekly basis, a segregated
22 investment report. Now both of these I should

1 say, the NFA and CME have already put into their
2 rules. We're just going to officially adopt them
3 under the Commission regulations. So there's
4 nothing there, but at least we will be getting
5 daily information from these firms.

6 On a notice standpoint, here I think on
7 the pre- event what we have proposed is more
8 information about, you know, anticipatory events,
9 whether they're acknowledgment letters from the
10 bank, we've opened up a new bank account, seg or
11 secured bank account, make sure we got the
12 acknowledgment letters. If there is a potential
13 of a material downgrade in creditworthiness, or
14 the ability of a firm to fund its obligations,
15 that would be something. If the firm felt that
16 there was potentially a problem for that, there
17 would be a pre-notification.

18 Or if there is a -- the firm is going to
19 get into a new line of business, establishing or
20 terminating a line of business, to pre-notify us
21 of that event. Or if they're thinking of changing
22 their clearing arrangements, or anything that

1 could impact liquidity is one thing that we want a
2 notice of ahead of time so we can understand
3 what's going on at the firm and make sure that the
4 appropriate actions are taken.

5 Some other proposed notices on a
6 post-event. If the firm discovers that -- or is
7 informed that it's invested funds inappropriately,
8 that would be something that they would have to
9 tell us that, yeah, we had a problem and we didn't
10 invest in accordance with 1.25.

11 If the firm does not hold sufficient
12 funds to meet its targeted residual. So all the
13 firms that have gone through an exercise under
14 Section 16 of the NFA rules to identify what their
15 targeted residual level is. So to the extent a
16 firm is going to -- falls below that targeted
17 residual, there would be a notification
18 requirement to us. So it's not that they are
19 under seg or under secured, but if they've fallen
20 below the targeted level that they think this is
21 where we should be at, there would be a
22 notification so we could then come and talk to the

1 firm and understand, okay, what happened, why did
2 it happen, and what are the circumstances.

3 If the firm has a material change in its
4 operations, all right, getting at our
5 understanding of the operations of the business,
6 the risk profile of the firm, so we can make sure
7 we're assessing the firm properly from an
8 examination perspective, that we're looking at the
9 right things. So if there's a material change in
10 the business line, entering into a new business,
11 that's something after the fact that, you know,
12 we're going to want to look at to say, okay, how
13 does this affect how we look at the firm, how we
14 risk assess a firm, and design the oversight
15 functions around that.

16 And then the final proposed reg is if
17 there is a notification by another SRO, the SEC,
18 FINRA, any of those notifications, would also have
19 to come to the Commission so that we would be
20 aware of an action taken by another regulator.

21 On the proposed public disclosures, I
22 think we're really getting at making sure that the

1 public is notified of similar things. You know,
2 what are the significant lines of business that
3 the FCM is in so that the public can get a level
4 of understanding of what is the risk of the FCM
5 that they're entrusting their funds with.

6 Disclosing selected financial data to make sure
7 that this information is out there so that the
8 public has the opportunity to understand the
9 financial information and can evaluate and do
10 their diligence on the FCM.

11 And then finally just a description of
12 the material administrative, civil, or criminal
13 litigation against the firm. So again, giving the
14 customers the opportunity to evaluate that in
15 their decision making process.

16 I think that's sort of a very quick and
17 high level overview of both what we're getting now
18 as well as the direction we're going in the
19 proposal for the future, trying to just balance
20 off pre-notification -- pre-event notification so
21 that we can make sure we understand where the firm
22 is, where they're going, as well as after the

1 fact, making sure we understand when something
2 does happen so we can properly evaluate that.

3 MR. BARNETT: And also allowing
4 customers to evaluate an FCM prospectively. Do
5 they want to choose a particular FCM or on ongoing
6 basis, what's the status of their FCM and what's
7 the risk orientation? What are the risks they're
8 facing with that FCM at that time?

9 Now we had a very broad discussion of
10 reporting and disclosure. We've had now -- this
11 is the third roundtable we've had on customer
12 protection, and the last one we talked about
13 reporting and disclosure. And at the end of it,
14 there was supposed to be a -- the buy side in the
15 industry. We're going to have a discussion. And
16 we haven't heard the results of that yet, so we'll
17 be reading the comment letters with interest.

18 And so our question to you is really,
19 you know, within the scope of our proposal both
20 with respect to reporting and disclosure, you
21 know. Do we need to refine the language that we
22 put in there to better pinpoint disclosures and

1 reporting needed by the respective recipient. It
2 may be the Commission on a lot of the reporting.
3 Some of the reporting and a lot of the disclosures
4 are for the customer.

5 And so it's kind of a, you know, how did
6 it come out and what comments do you have on what
7 we proposed? And that is really a very broad
8 question, but it does follow on a number of you.
9 Many of you were at the last roundtable, and we'd
10 like to get your feedback.

11 MR. THUM: Gary, could I kick it off?

12 MR. BARNETT: Yes.

13 MR. THUM: So I represent Vanguard.

14 We're the buy side, real money managers, \$2
15 trillion under management and nine million
16 shareholders. We have a conservative approach to
17 using swaps and futures and FX to hedge portfolio
18 risk, lower transaction costs, and achieve more
19 favorable execution.

20 Currently we trade over the counter, and
21 our swaps are fully collateralized on a bilateral
22 basis, collaterals held by a triparty custodian

1 arrangement. And there's no or limited fellow
2 customer risk, fraud, or malfeasance risk,
3 investment risk, or operational risk.

4 We applaud the CFTC's efforts over the
5 past year to tighten protections afforded to
6 customer, particularly addressing investment risk,
7 margin shortfalls, fellow customer risk, and
8 financial requirements. But at the end of the
9 day, from our perspective, the main thing that we
10 consider is the ability -- the best protection we
11 have is the ability to port our trades to a new
12 FCM if we consider our existing FCM to be at risk.

13 So the rules that we're talking about
14 today largely go at the issues and provide the
15 information that we're looking for to make a full
16 and complete assessment. Vanguard seeks to
17 protect shareholder assets that are transferred to
18 the FCM. Given the margin will not be held by a
19 custodian, it's imperative that Vanguard has
20 access to meaningful timely information about its
21 FCMs.

22 And while we support the FCM reporting

1 to the CFTC and to the SROs, such information must
2 be made public. The information can't be withheld
3 all together or released long after it's valuable
4 in terms of allowing customers to assess their
5 FCMs.

6 So among the FCM -- among the current
7 and proposed reporting requirements, the following
8 are areas that we would be most interested that
9 clients have access to. First is segregation
10 computations, the daily reports that FCMs must
11 hold funds needed to cover the equity of each
12 customer. We'd like to see that released publicly
13 on a daily basis. The monthly report on residual
14 interests showing the FCM's targeted residual
15 interest in the customer account.

16 Now note that we think this should be
17 amended to show the daily levels of the residual
18 interest or the average level in a month, not
19 simply the residual interest at month end. And we
20 also think the FCM should put this information on
21 their website for the preceding 12-month period.

22 In terms of financial statements, you

1 mentioned the monthly unaudited and yearly audited
2 statements. We're glad to see the yearly
3 financials will be public. We'd also prefer to
4 see the monthly unaudited financials, given that
5 they're a much more timely presentation of the
6 FCM's health. We'd also -- we're glad to see the
7 monthly reports include capital levels. We'd also
8 like to see the monthly report include the balance
9 sheet leverage ratio, which was referenced in the
10 release.

11 In terms of reportable events, currently
12 the reportable events include failure to maintain
13 capital levels, failure to maintain books and
14 records, failure to comply with segregation. In
15 the proposed requirements, we also think that they
16 need to be made public, and these relate to
17 investments not being in compliance with Rule
18 1.25, a failure to hold targeted residual
19 interest, FCM parents or their affiliates having a
20 material adverse change, or an FCM having a
21 material change in its operations or risk profile.

22 We need to see these made public to

1 create a level playing field for customers to
2 assess the viability of their FCMs. Certainly
3 Vanguard has wonderful relationships with its
4 existing FCMs and has a close understanding of
5 their health. That's why we chose them, and we
6 have a rigorous due diligence process to assess
7 them regularly. Not all clients have that same
8 window into their FCMs. And to better protect the
9 market, and to also encourage the FCMs to comply
10 with the rules, we feel it's imperative that these
11 reports be made public.

12 So again, at the end of the day, if the
13 reports are made public, it provides the ultimate
14 back stop for all the protections that have been
15 written into the rules by allowing information to
16 flow to the customer so they can port their trades
17 to a new FCM ahead of a default.

18 MR. COCCO: Gary?

19 MR. BARNETT: Yes.

20 MR. COCCO: May I just say a few things?

21 MR. BARNETT: Go ahead, Alessandro.

22 MR. COCCO: Alessandro Cocco from JP

1 Morgan. We're an FCM. And wanted to mention that
2 we support the vast majority of the changes that
3 are being proposed here, and the disclosure to
4 regulators, to our clients, and to the public.

5 I'll get to the point where I say that
6 there are some areas where we think that some
7 thought has to be given about what is disclosed to
8 the public. But let me tell you what we support
9 first, so I'll tell you about all the great things
10 that we think are wonderful.

11 Mr. Barnett: Oh, good.

12 (Laughter)

13 MR. COCCO: So Regulation 1.55(o) for
14 instance, the daily seg disclosure, adjusted net
15 capital, excess net capital, we think all of all
16 that is absolutely fine. We support that fully.
17 We completely understand the reasoning behind it.

18 Some of the early warning signs that in
19 the current proposed regulation are to be
20 disclosed to the regulators, we actually support
21 that because given that they are early warning
22 signs, we think that regulators need to have some

1 time to be able to perform their function, which
2 is to either stabilize the patient or provide for
3 an orderly transfer of customer positions. So
4 that is for purposes of protecting customers in an
5 orderly manner. And I'm referring to 1.12(h),
6 (i), (j), (k), (l), (m). We support also several
7 of the additional proposed rules that I think have
8 to be seen in the whole context of the proposed
9 changes. So for instance, 1.11, the risk
10 management program requirements, we think those
11 are very thorough and completely understand the
12 reasoning for them. The stricter audit
13 requirements under 1.16 also make a lot of sense,
14 of course. And the stricter FCM examination
15 programs by SROs under 1.52, also completely
16 support them.

17 So here's where I get to the part where
18 we have some comments. And I'm thinking mostly
19 about 1.55(k), which has a number of subsections.
20 For that, we recommend harmonization between the
21 various regulators, so NFA disclosure --
22 disclosure to NFA to the CFTC to FINRA, the SEC,

1 and so forth, just so that we can compile these
2 statements in a way that allows us to use them
3 across the board. Hopefully the information that
4 we're required to disclose is essentially the same
5 information so we can do that in an efficient
6 manner.

7 And then getting to the specifics, for
8 instance, of 1.55(k)(10)(ii), (iii), (iv), and
9 (vii). These are some of the examples of matters
10 that we think are more suited to be disclosed to
11 regulators and maybe to clients who request it on
12 an RFQ basis, but to disclose them to the whole
13 broad public may be problematic for us. And
14 again, it may hinder what we understand to be the
15 purpose of the proposed regulation, which is to
16 protect clients.

17 So I'm thinking specifically of
18 1.55(k)(10)(ii), the dollar value of the FCM prop
19 margin. We struggled to see the benefit of
20 disclosing it to the broad public, or the number
21 of futures customers, you know. We can disclose
22 it on RFQ. Of course, full transparency to

1 regulators, but to the broad public, that gets
2 into the area of, you know, our commercial
3 interests and our competition with other FCMs.

4 Also the non-hedge principal OTC
5 transactions under 1.55(k)(10)(iv) is also, you
6 know, something we would disclose on an as needed
7 basis. And finally the balances written off. We
8 think that that can be a little bit misleading,
9 you know. In other words, did we write them off
10 because there was a problem with the client or
11 because we don't know how to run our business?
12 So, you know, that is information that needs to be
13 disclosed with some commentary around it and to
14 the appropriate recipient. So that's, broadly
15 speaking, where we are.

16 MR. BARNETT: Thank you. Ron.

17 MR. FILLER: Yeah. I just want to add
18 what Bill and Alessandro. I mean, there's a
19 tremendous need for that balance of what is public
20 and what is reported to the regulators on a
21 confidential basis. And we all can disagree or
22 agree on some of the basic reports.

1 I was on the NFA committee that led to
2 Section 16 in all the reports that we did. And
3 Tom can correct me if I'm wrong, but I think it
4 was only comprised of the public directors at the
5 time. I'm not sure whether any industry directors
6 were on it. And we went through a survey of all
7 these reports that were going to be recommended,
8 and I'm not sure if it was unanimous, but it was
9 pretty unanimous among the public directors of NFA
10 which of those reports should be made public.

11 And we recommend also that those reports
12 that should be made public to the general public
13 be done on the NFA basic website under each FCM so
14 there's one source, as opposed to having it on the
15 FCM website and everything, we highly recommend
16 whatever reporting that has to be done to the
17 public go through the NFA website. It's called
18 Basic, and you can write in or type in anyone's --
19 any firm and get all the information about that.

20 So I think it's a delicate balance.
21 There are different views, but I think the more
22 and more you decide which of those things should

1 be -- reports should be made public and non-public
2 is very critical. And, you know, I look forward
3 to hearing more discussion among the group here.

4 But we did that on a report by report
5 basis on this special committee, and we came up
6 with what we thought were proper reports that
7 should be made public and those that should be
8 made only to the regulators. So they're going to
9 NFA or to the CME right now, and whether you guys
10 get access to it or not. I mean, I think
11 sometimes it should be for your eyes only, and
12 then if you want to require something more down
13 the road, that's something that the regulators can
14 then decide.

15 MR. BARNETT: Thank you. Grace?

16 MS. VOGEL: I agree with Ron's comments.
17 I have a concern that if certain information is
18 made public too early, it could create a run on
19 the firm. Liquidity is the lifeline of
20 broker-dealers and FCMS, and if lenders lose
21 confidence and there's a run on the firm, then the
22 customers may end up in a SIPC liquidation.

1 We have certainly had instances where we
2 were aware of issues and we worked with firms to
3 transfer customer accounts on an orderly -- in an
4 orderly fashion to another broker-dealer and
5 another FCM.

6 MR. BARNETT: Can I -- just for the sake
7 of conversation, I want to push back a little bit
8 on both comments.

9 So I remember that, for instance,
10 whether -- and Tom can correct me if I get this
11 wrong. But the NFA's notice to the public that an
12 institution was engaged in prop trading would be a
13 check the box. And I also remember dealing with a
14 crisis entity that we were involved in where the
15 public securities markets were getting information
16 because an affiliated parent had public
17 securities, but the FCM customers, at least not
18 directly, weren't getting any information
19 directly. But there was public information out
20 there, but really for the securities markets.

21 And I just am not sure that I find --
22 and I understand the run on the bank concern. But

1 in terms of finding the balance, I'm not sure
2 that, you know, check the box on one item is
3 enough, and I'm also concerned how far one would
4 push the, you know, the information back into the
5 entity. If people want to invest a million
6 dollars into an operating company, they get
7 disclosure. If they want to, you know, put it
8 into a commodity pool, they get disclosure unless
9 there's some sort of exemption. But then they
10 entrust it to an FCM, and there's a markedly
11 different amount of information that's available
12 to the customer. And I'm not sure that --

13 So I take the points, and there is a
14 balance there needs to be there. There's
15 competitive, there's confidential issues, and so
16 on and so forth, that need to be taken into
17 account, but balanced against the interest of
18 customers who are entrusting funds to these
19 institutions. Go ahead.

20 MS. VOGEL: FINRA has rules that
21 restrict broker-dealers in the event they're
22 approaching financial difficulty. And that

1 financial difficulty can be as a result of, you
2 know, certain capital levels, or it could be
3 because of operational problems, or liquidity
4 problems.

5 We have some latitude with respect to
6 restrictions, and those restrictions would be, you
7 know, maybe not taking on additional customer
8 accounts, not opening new offices, not increasing
9 the size of the balance sheet. Those restrictions
10 vary depending upon facts and circumstances, but
11 that may be something that you want to consider on
12 the FCM side.

13 MR. BARNETT: That's a good point.

14 MR. THUM: If I could just push back a
15 little bit, too, on this concept of a run on the
16 bank, you know, I think, first of all, you know,
17 when you think about a run on a bank, we've got
18 banks that take in short-term deposits and make
19 long-term loans. So obviously if something
20 happens with the bank, they don't have the money
21 to pay the depositors out immediately. FCMs, on
22 the other hand, are getting customer assets as

1 margin to cover their trading under the rules that
2 have been passed and that are proposed even in
3 this proposal. The margin levels -- each customer
4 is meant to pay their own fee. Each customer is
5 meant to put the margin in and ultimately get the
6 margin back.

7 And the concern that I would have and
8 certainly for Vanguard shareholders is that
9 there's information that is going to the CFTC or
10 the SRO that if it was in the market, would allow
11 each client to make a decision, is it appropriate
12 to continue to use that FCM as your FCM, or do you
13 need to find a new one?

14 I also think that while in the past
15 we've lived in a world where there has not been
16 full and complete disclosure to the public, and it
17 has been more on an ask, and if you're a great
18 client you may get some information basis. If in
19 the future these reports are common knowledge and
20 are out there on a regular basis, they will be
21 taken into consideration by individual clients so
22 that they will not necessarily act on a knee-jerk

1 basis and move their money, but they'll be
2 thinking about their business relationship,
3 whether or not the failure to satisfy or comply
4 with an obligation is an administrative error that
5 can obviously be fixed, can easily be fixed, and
6 look at their alternatives in terms of whether or
7 not there is an FCM that can take their trades.

8 So I push back a little bit on this run
9 on the bank, you know. If there is a problem with
10 our FCM, I would rather have the information, be
11 able to take the margin, which the FCM is required
12 to maintain, take that and transfer it to a new
13 FCM, and port our trades.

14 MR. COCCO: I think it helps to be
15 specific. So in other words, you know, I agree
16 with every statement that has been made. So the
17 question is, so how do you apply? So for
18 instance, what Bill was saying, which I agree
19 with, you know, you need to know where you stand
20 as a customer. So let's go down to the details.

21 So if that means daily statement of seg
22 requirements, then I understand that. If that

1 means that you want to know my proprietary
2 positions, then maybe I see that a little bit
3 less. So, you know, I think it'll go down to the
4 specifics of each proposed regulation and then,
5 you know, thinking about whether that specific
6 proposed regulation is suitable for disclosure to
7 the full public, to customers, or just to
8 regulators.

9 MR. FILLER: Can I just further comment
10 on what Alessandro just said? As Kevin was going
11 down all these post-event reportings, many of them
12 deal with what I'm going to put under the big
13 umbrella "early warning" type issues. To me,
14 those should be for the eyes of the regulators
15 only because how you interpret it -- a lot of
16 times you have an early warning, and you can fix
17 the problem within the 24- or 48-hour window.

18 And so I think it's very important that
19 when you deal with some of these post-even
20 reporting, those should only go to the regulators,
21 not be made public. If the regulators think that
22 there should be some enforcement action brought,

1 it will be made public in a very short period of
2 time. But I think a lot of those types of reports
3 are for the eyes of the regulators only, and it
4 gives you guys a better opportunity to do your
5 right job.

6 MR. THUM: And I think I agree as well.
7 I think it's fair to make a distinction, which is
8 in my opening remarks I focused on, I think, five
9 different areas that we really felt were
10 appropriate for public reporting -- immediate
11 public reporting. And I think some of the points
12 that Alessandro was saying probably are more of a
13 competitive business nature, so maybe aren't
14 completely appropriate.

15 But I think the things -- the key things
16 of the segregation computations, the residual
17 interests, the financial statements, the
18 reportable events, and the -- and also one that I
19 didn't mention -- I overlooked -- was the twice
20 monthly reports on investment data. And that's
21 one that we actually do talk to our FCMS about
22 quite a bit, and they actually use it as a selling

1 point so they can invest the assets and the broad
2 range of options under Rule 1.25.

3 Some of them report at the top and the
4 most liquid end. Some of them invest at the top,
5 and some of them invest otherwise. We tend to
6 favor FCMS that have a more conservative approach,
7 so we'd like to see that report as well.

8 MR. BARNETT: James.

9 MR. KOUTOULES: I think those are all a
10 good start. I think we need to go a little bit
11 further, though, than your proposal on Rule 1.10
12 to expand reporting on balance sheet leverage.
13 Monthly is a good start, but if you look at what's
14 available on other aspects of the market, such as
15 the CTA, CPO side, which is where I represent, any
16 sophisticated investor could look at monthly
17 numbers and get somewhat of an idea, but you
18 really need to look at what's going on on an
19 intra-month basis.

20 We've seen multiple issues on the
21 securities world having to do with window dressing
22 and firms simply getting their leverage

1 requirement in there the last day of the quarter.
2 And I think by mandating that FCMs only disclose
3 their balance sheet leverage on a monthly basis,
4 it doesn't go far enough.

5 I'd like to see average leverage over
6 the course of the month and also the peak leverage
7 to try to curtail the window dressing practice.

8 MR. PICCOLI: Okay.

9 MR. BARNETT: Reactions to that?

10 MR. THUM: Well, I certainly agree.

11 MR. PICCOLI: If I can just follow up on
12 Ron and Alessandro. You know, one purely
13 hypothetical situation, you know, we talk about
14 being careful, you know, disclosure whether it's
15 under seg issues because, yes, you can have a firm
16 that something happens and they go under seg, but
17 cure it within 24 hours.

18 So there is caution to be had on
19 disclosing something like that to the public,
20 don't misunderstand what happened, don't have all
21 the details and the facts that the regulator would
22 have in responding to that. But would it be

1 beneficial or harmful, for that matter, if, let's
2 say, within a 24-month period or 12-month period
3 saying, well, you know -- and, again, purely
4 hypothetical, that a firm might have gone under
5 seg four or five or six times during that time
6 frame.

7 And it all may be very legitimate
8 operational errors that just happened, but, you
9 know, is there a merit to looking at that type of
10 disclosure to help the public be aware that, okay,
11 you know, they had a one-off, but now it's four
12 one-offs within a one-year period.

13 MR. FILLER: Oops, sorry. My only
14 comment is you brought an enforcement action
15 against an FCM that did not or was under seg for,
16 I think, it was over a weekend and another day or
17 so. So the CFTC has acted very promptly in
18 bringing an enforcement action against that firm.
19 The question is, under what circumstances should
20 those types of notices be brought, made public --
21 and enforcement action is made public. And if
22 that's not a better way of saying this firm is not

1 -- wasn't consistent, you know, you can take that
2 approach.

3 I don't know what the right number is,
4 Kevin.

5 MR. PICCOLI: Yeah.

6 MR. FILLER: Should there be a number?
7 But I think it's more important for the CFTC to
8 know that an FCM is under seg so you can take the
9 appropriate actions.

10 MR. PICCOLI: Yeah, you're right on the
11 enforcement action, though unfortunately it takes
12 a little bit of time before those enforcement
13 actions become public.

14 MR. COCCO: I think you want to create a
15 culture where very, very, very quickly after or at
16 the time when a problem is discovered, one of the
17 first calls is to the regulator to say, look,
18 there's something, we're looking into it. And now
19 I'm saying that if you have full knowledge that
20 that's going to go straight through to everyone,
21 then that will make you want to understand what's
22 going on before you call regulators and maybe take

1 a little bit more time.

2 You know, it's just a fact of fact,
3 because if it's kind of a suicide note to say,
4 look, there may be a problem and then the market
5 essentially completely moves away from you, it
6 becomes a self-fulfilling prophecy. So I think,
7 again, it's about the specific facts, specific
8 issues in each case. But I think you also want to
9 create a culture of transparency, but also of
10 being able to raise issues while you're
11 investigating them internally. So I think that
12 will increase systemic stability.

13 MR. BARNETT: James.

14 MR. KOUTOULES: I agree completely that
15 transparency and enforcement is very important. I
16 think that adding new rules is incredibly
17 important. But even more so is that the actors in
18 the marketplace need to know what the penalties
19 are so that, one, they can make sure they're
20 compliant, but, two, to create a deterrent from
21 breaking those rules.

22 So, for example, in your proposed change

1 to Rule 1.20 where we're labeling the accounts as
2 customer segregated account, I think that's a
3 great change, but we need to know what's going to
4 happen if someone breaks that rule. So, say,
5 someone -- let's call him John Corzine --

6 (Laughter)

7 MR. KOUTOULES: -- decides to transfer
8 money out of the customer segregated account and
9 use it to meet a margin call at a bank -- let's
10 call it JP Morgan -- what's going to happen to
11 Corzine and JP Morgan? So, like, for example, MF
12 Global, JP Morgan is still holding customer
13 segregated funds that were transferred to meet a
14 margin call over a year ago.

15 So where's -- you know, what's the
16 enforcement action there? Like that needs to be
17 clear so that situations like that don't happen
18 again.

19 MR. BARNETT: Okay. Well, you know,
20 obviously we're not going to comment on MF Global
21 or anything where we have ongoing matters. But
22 the idea that we have -- I mean, it's so fact

1 driven and there's so many other -- I mean, I'm
2 not sure there's a way to do that, but I heard
3 what you said.

4 Other thoughts? Michael.

5 MR. GREENBERGER: Yes. First of all, I
6 want to congratulate you on the proposal. I mean,
7 we can debate refinements to it, but I think the
8 overall direction is very good, and I think when
9 implemented will do a lot to re- establish the
10 reputations of these markets which have been so
11 badly damaged.

12 I agree that careful thinking has to go
13 into drawing the line between not proprietary
14 investments, but proprietary information when
15 you're disclosing proprietary information that
16 really I don't think is going to help the customer
17 all that much. I think there's a lot here that we
18 can agree on that will help the customer a lot.

19 In that vein, whatever the resolution of
20 the problem is, I would caution in establishing
21 what you want disclosed and not using the
22 likelihood of enforcement as being a deterrent

1 because, let's face it, not everything gets
2 enforced. And, secondly, I think once we decide
3 what's important for the customer to know, a lot
4 of the value here -- we don't want runs --
5 unnecessary runs on financial institutions. But a
6 lot of the value here is to let the customer know
7 what's going on, not relying on the CFTC
8 enforcement completely or SRO enforcement, but
9 relying on the customer having knowledge to make
10 intelligent decisions.

11 The other thing why I agree with a lot
12 of what Ron had said, knowing particularly -- the
13 problem with MF Global and Peregrine is you've got
14 a lot of unsophisticated customers. You don't
15 have the big buy side people, as I understand it,
16 getting swept up and damaged as much as you do the
17 rancher, the farmer, et cetera, et cetera.

18 So I would not limit posting the
19 information on one website like the NFA website.
20 I think it should go -- now again, I'm not saying
21 proprietary investment information or anything
22 else. I think we have to be very careful about

1 what's useful to the customer and what is
2 unnecessary disclosure in terms of proprietary
3 investing decisions.

4 But once that decision is made, I really
5 think it should be put up wherever it can be put
6 up. Using the NFA websites, I mean, for the
7 skilled and people who are in the industry all the
8 time, that sounds pretty easy. But to a customer
9 accessing that website, as opposed the most
10 natural thing would be to go to the FCM's website.
11 So I think when we decide what needs to be
12 publicly disclosed, it should be disclosed
13 reasonably, not unnecessarily, but reasonably on
14 the broadest basis possible.

15 The other thing that I think is the
16 final thing I would say, I think is terribly
17 important, is whenever we decide what is going to
18 be done, I think there need to be checklists or,
19 Kevin, just the way you in some way went through
20 this saying here's a list of things pre-event,
21 post- event, everything else, because I applaud
22 the carefulness and detail of the notice of

1 proposed rulemaking. But when you combine that
2 with the regulations, interpretations, and
3 everything else, it's hard for somebody to go to
4 one place at one time and say, this is what I know
5 I can get. And that really should be backed up
6 with webinars for investors and everything else,
7 because from my experience, the small investor has
8 this global -- at least prior to MF Global had
9 this global assurance that the safest place they
10 could put their money was in a segregated account
11 in FCM, even if they weren't doing futures
12 trading, that it was better than having it in a
13 savings account.

14 And I think there needs to be much more
15 sophistication given to customers, especially
16 small customers, about what this is all about,
17 what the risks are, and what the tools are that
18 you have to make sure that your money is, in fact,
19 segregated.

20 MR. BARNETT: Thank you. I think that
21 -- I mean, one small point I think to put things
22 in perspective a little bit is that all of it fits

1 together. I mean, the idea that, you know, you
2 have rules that say don't speed, and then you rely
3 on enforcement or, you know, the police guy
4 catching you and giving you a ticket versus, you
5 know, sufficient risk management requirements, and
6 control- oriented examinations, and disclosure to
7 customers that informs them, but also
8 incentivizes, good controls. Finding that
9 balance, though, is important to see it all -- how
10 it fits together.

11 But I think that too much reliance on
12 just deterrence puts us back to where we were, and
13 nobody can catch it all. And if you just are
14 going to go -- you know, rely on the stated rule,
15 like you will seg funds, and if you don't we'll
16 get you afterwards and give you a -- it doesn't do
17 enough risk mitigation.

18 MR. SEXTON: Can I just mention just a
19 few things. Tom Sexton from the NFA. And as Ron
20 indicated, our special committee of public
21 directors went through this process already with
22 regard to some of this information, some of the

1 considerations I think that the Commission is now
2 considering as far as reporting and disclosure.

3 I think Ron is exactly right. There is
4 this balancing that needed to occur. And the
5 balancing is not only what should be made public
6 and not public and reported only to regulators,
7 but the factors that I think the committee took
8 into account were there's a balancing of firm
9 type, FCM type. So I think we always like to
10 picture the largest FCMs being -- and what they
11 should be disclosing.

12 But you also have to realize that there
13 are smaller FCMs, and how this disclosure of some
14 financial data may appear in light -- in
15 comparison, I guess, to the larger FCMs I think
16 can be somewhat misleading if you look at numbers
17 alone. And it's very hard to qualitatively
18 describe differences in those numbers when people
19 only are going to be looking at numbers, I think.
20 So you have the size of the FCM.

21 The other thing that I think the
22 committee balanced is, and this goes to more of

1 the customer type and who's going to be reviewing
2 this information. And obviously we run, you know,
3 the whole gamut between retail customers and
4 institutional customers, and certainly some of
5 this information may be very worthwhile to
6 institutional customers. But the retail customer
7 is going to get lost in this, the complexities of
8 this information.

9 That was something that our committee
10 balanced in coming up with what is -- at least
11 what basic information should be provided to
12 everybody, retail, institutional, that would be
13 easily understood.

14 So when I look at the proposal, I think,
15 and hearing the comments today, I really think
16 there are three buckets that the Commission should
17 consider. And I'm not here to tell you what falls
18 within each bucket. I think you're going to have
19 to listen to the comments on that. But one is in
20 general what should be made available with regard
21 to all FCMs. The second is what should be made
22 available mandatorily upon request by customers, I

1 think. And the third is, and this goes to Grace's
2 concern and others, is what should only be
3 reported to regulators because the regulators have
4 to do their jobs and have to assess the firm and
5 make sure that if there is a lifeline to give to
6 that firm, that the firm has adequate time to do
7 so before information hits the market that may be
8 totally disruptive to everything if it can solved
9 short of that.

10 So those to me are the three buckets.
11 And I can tell you that when it comes to issues
12 like proprietary trading, and that was something
13 that was brought up, and we had a long discussion
14 on proprietary trading and what to make available
15 or what to disclose. And ultimately we decided
16 that, and this goes to the harmonization issue,
17 that there has to be harmonized definitions as to
18 what proprietary trading is, what leverage is,
19 because we collect leverage now on a monthly basis
20 from our FCMS.

21 I can tell you that depending on that
22 leverage calculation, for example, whether or not

1 you include seg funds in the calculation or not,
2 you come up with vastly different results for that
3 leverage calculation that if you were to show that
4 publicly I think could potentially be very
5 misleading as to what the condition of that FCM
6 is.

7 So these are all tools I think that we
8 can use as regulators, that perhaps there's some
9 way to achieve definitional conformity, I think,
10 among different regulators as to what should be
11 made public. But that's a lesson and a time that
12 we're going to have to take to do that. And you
13 can't just say, well, this is what the definition
14 is going to be because, as I said, it could be
15 vastly in the securities world or someplace else.

16 MR. BARNETT: Yeah, Mark?

17 MR. HOLLOWAY: I'd like to just pick up
18 on those thoughts, speaking, you know, for Goldman
19 Sachs and for SIFMA. We certainly, too, applaud
20 the direction in which your proposal is going and
21 the things that you're trying to achieve.

22 We would note -- I guess I'll speak now

1 for the SIFMA Group, but we would note that firms
2 -- and again, I'm picking up on Tom Sexton's
3 thought -- are at very different places with
4 respect to a lot of these requirements. For
5 example, if an FCM is included within an
6 organization that is a public corporation, is
7 included with an organization that ultimately is a
8 financial holding company or a bank holding
9 company. It's already meeting many of the
10 requirements and has been for some time.

11 But the CFTC is proposing, and
12 additionally an awful lot of public disclosure
13 surrounds our meeting those requirements. And I
14 think our concern and hope is in terms of
15 harmonizing your requirements with pretty
16 substantial and detailed requirements to which
17 we're already subject.

18 Again, we applaud the direction, but I
19 think some folks -- some types of firms are
20 already doing an awful lot in the context of the
21 goals you're trying to achieve.

22 MR. BARNETT: Thanks. Yes?

1 MR. KOUTOULES: I think the NFA has made
2 a great start with the financial reporting that's
3 available on basic. And the last thing I think
4 anybody wants to do, especially the retail
5 investors, is drown them in information which
6 would have the effect of burying relevant
7 disclosures under a sea of meaningless data.

8 But a couple of things I'd like to see,
9 and this something that maybe Tom and I could talk
10 about separately, but is to see things -- a little
11 bit of analysis on there. Like see the ratio of
12 excess seg to seg funds listed on the website.
13 Look at things like your proposed revision to 1.10
14 and balance sheet leverage, and put that number on
15 the website. And, you know, hopefully throw in
16 that average over the month and peak leverage as
17 well.

18 And I think we'd also like to see that
19 data and being able to be manipulated a little bit
20 easier, like maybe downloadable Excels or a
21 mechanism to compare FCMs right next to each other
22 a little bit easier, because I haven't spent all

1 that much time with the system, so correct me if
2 I'm wrong. But I think to access each firm,
3 you've got to type in their name and look at them
4 individually.

5 So, I mean, it might be a little bit
6 better if you could look at them all side by side
7 and maybe, say, group the bank FCMS together, and
8 the BD/FCMS together, and the firms that handle
9 more hedge business, or smaller spec business. A
10 little more peer group analysis.

11 MR. BARNETT: Thank you.

12 MR. HORGAN: Hi, this is Rich Horgan.
13 Just to address the balance issue, maybe to extend
14 Tom's approach would be for the regulators to
15 gather a lot of this information and allow some
16 time to analyze the data, and then bring forward
17 more public disclosures.

18 I think some of the concerns that are
19 raised here, for example, the proprietary trading
20 or some of the seg fund information. If you allow
21 the regulators to analyze the data collected and
22 then over a time period continue to disclose that

1 information, whether it be on the FCM's website or
2 through the regulators, the NFA, that might be a
3 more appropriate approach versus just disclosing
4 everything immediately and potentially confusing
5 whether that's the large investor or the smaller
6 investor.

7 MR. BARNETT: Thanks, Rich.

8 MR. TIRRELL: Gary, just to build on
9 what has already been said, I think the key factor
10 here, too, is making sure there's harmonization in
11 the description of the terms that are being used,
12 like "liquidity," and "leverage," and so on. I
13 think there's some different definitions out there
14 that could be applied across, say, a broker-dealer
15 versus an FCM. And I think those standards need
16 to be harmonized in order to give a much clearer
17 and level playing field for the client.

18 MR. BARNETT: Okay, thank you. Could we
19 go back for -- do you have another -- I wanted to
20 ask about the issue that was raised about -- Tom
21 raised about the smaller firms and also the retail
22 customers. I mean, we -- the closest we could

1 come to deal with that situation was we added to
2 1.55(b) standard -- additional standard
3 disclosures where we thought that they had not
4 understood things. We got input from people that
5 there were things they were surprised by, and so
6 we tried to beef that up.

7 But we didn't think that that should
8 mean that we'd get less information that more
9 sophisticated investors -- customers were asking
10 for in their analysis. So we just kind of added
11 in 1.55(b), and then we added the additional
12 disclosures that the more sophisticated investor
13 should have.

14 I hear the concern that smaller firms
15 may not be able to -- may be concerned about what
16 information is being shown, that that might put
17 them at a competitive disadvantage. But how can
18 we balance that when the -- how should we balance
19 that? It's a reasonable goal, but on the other
20 hand, on the other side of the teeter-totter, it's
21 still customer protection of their funds. So what
22 are some of the things we should think about for

1 -- and if you don't have some of those shops, then
2 your retail customers also don't have a place to
3 go. So we're aware of that as well.

4 So thoughts about the retail customer
5 and the smaller shops? I mean, more thoughts
6 about how to accommodate those concerns, and yet
7 protect customer funds? James?

8 MR. KOUTOULES: I think just market
9 forces in and of themselves prevent the smaller
10 customers from doing business with a lot of the
11 bank FCMs. A lot of those FCMs have million
12 dollar minimums to open a clearing account, and
13 that's just not feasible for a retail customer.

14 So I think you have to look at the
15 existing market structure for those retail FCMs
16 and see what's working, what's not. I know one
17 selling point that some of the leaders in the more
18 retail-oriented FCMs are using is that they don't
19 engage in prop trading. Or if they do engage in
20 prop trading, it's done in an entity separate from
21 the FCM so that you don't have the risk of a
22 blowup at the -- on the FCM seg account

1 potentially affecting customers.

2 So I think really the main focus should
3 be making sure that those FCMs are compliant.
4 They setting adequate reserves. They're not over
5 leveraging, but then allowing them to disclosure
6 their prop trading policies, and what kind of
7 risk, if any, they're taking that could impact
8 customer funds.

9 MR. BARNETT: Todd?

10 MR. KEMP: Yeah. Following up on James'
11 comment a little bit, our members are primarily
12 hedgers. They're green companies that purchase
13 from producers and then hedge their risk, all the
14 way from very large to very small. But, you know,
15 in terms of the kind of information that they'd
16 like to see, a couple of thoughts.

17 Number one, a lot of firms really are --
18 they see it's very important doing a greater level
19 of due diligence today, particularly post-MF
20 Global. We need that information up front. We
21 also need -- you know, without getting into a
22 judgment of what's appropriate to reveal to

1 regulators and what's appropriate to reveal to the
2 public, they do need information on FCM
3 performance. And maybe early warning is the wrong
4 way to put it, but the ability to switch to
5 another FCM. They need some public information to
6 make those kinds of judgments.

7 I would say, too, that we're very
8 sensitive to the concern of unequal impacts on the
9 very large FCMs versus some of the smaller to
10 mid-size FCMs. Those are typically -- the smaller
11 mid-sized firms are typically the FCMs that our
12 members do business with often due to historical
13 relationships, personal relationships, a higher
14 level of hands-on personal service. And we would
15 certainly urge the Commission to be cognizant of
16 any sort of unequal results as a result of the
17 information that is available to the public.

18 Having said that, I think we would err
19 more toward the side of more public disclosure
20 instead of less.

21 MR. BARNETT: Okay. That's a hard
22 balance.

1 MR. THUM: I think building on that, and
2 I certainly agree with those comments, you know.
3 Particularly in the swaps market you have to keep
4 in mind that there's going to be a certain range
5 and a large range of standardized swaps that are
6 mandated to be cleared, and there simply will not
7 be another way to trade those swaps. So I think
8 it becomes even more imperative that information
9 about the FCMS is made public, and the folks that
10 are forced to clear in that manner have that
11 information to be able to make that decision.

12 I would also question that following MF
13 Global and Peregrine, I think that small or large,
14 everyone is focused on due diligence and is hungry
15 for that information to be able to make those
16 decisions, because they know -- I mean, certainly
17 the point that was made on the other side of the
18 group here, before MF Global and Peregrine folks
19 may have thought that putting margin up to their
20 FCM was the best protection they could ever have.
21 Certainly now they know that's not the case.

22 I think it will be much, much better

1 tomorrow given all that the CFTC has done. But
2 notwithstanding all the protections CFTC has
3 implemented, information, and the ability to port
4 is the final backstop for clients to protect
5 themselves.

6 MR. FILLER: I just want to cheer
7 everyone else's thoughts. I think the CFTC is on
8 the right -- taken the right approach and
9 direction. I mean, if you think about it, if you
10 pass or adopt many of the proposed rules, all
11 investors, whether you're retail or institutional,
12 is going to get a lot more information than
13 they've ever had before. Is it the proper amount?
14 Should there be more? I mean, time will tell.
15 But none of this information in the last 40 years
16 has ever been disclosed.

17 And within a few months after you adopt
18 these rules, there's going to be a lot more
19 disclosure required. You're changing the 1.55
20 standard risk disclosure statement and adding more
21 disclosure regarding those lines. I mean, I think
22 from a balancing and everything, I think it's the

1 right direction what you guys are doing or what
2 the Commission is doing and what the NFA has done.

3 The other part of it is -- I mean, we
4 all have to protect the retail customer, and every
5 rule and regulation by the CFTC or the SEC or any
6 regulators protect the public customer. But to be
7 honest, in the futures and now the swap industry,
8 the percentage of players who are, quote, "retail"
9 is getting smaller and smaller. It doesn't mean
10 it doesn't need the proper customer protections,
11 but I think with these extra disclosures, they're
12 more informed.

13 NFA or CFTC, I think one of the
14 responsibilities of both is to provide more
15 education, consumer education, and advice. And
16 the more we do, I think we're just going to be a
17 healthier industry going forward.

18 MR. BARNETT: Thank you. Yeah.

19 MR. KOUTOULES: This may be a little bit
20 beyond the scope of this panel, but one of the
21 things that we've really seen from the retail
22 customer is a desire to have some kind of

1 insurance regime. And, you know, there's
2 different ways to go about implementing such a
3 thing, like Commissioner Chilton has put forward
4 his plan. We've seen a lot of pushback from that
5 from some of the exchanges and bigger players who
6 don't want to pay for the insurance.

7 And so in response to that, our
8 organization has worked with some other
9 organizations, like National Grain and Feed and
10 some of the exchanges, some of the more retail-
11 oriented FCMs, and developed a plan for private
12 opt-in insurance. We shared that with the Senate
13 Ag Committee and have talked to Commissioner
14 Chilton about it as well, and plan on showing that
15 more to NFA and the CFTC, should you be
16 interested.

17 MR. BARNETT: Okay, thank you. Michael?
18 Sorry, go ahead, sir.

19 MR. WOLF: Okay. From the agricultural
20 production side of things, we look at things just
21 a little bit different. We aren't looking at
22 investments. We're looking at risk management

1 tools, and that's an entirely different game than
2 what we do anywhere else. We're looking at
3 protecting the market movements in our funding.

4 What has happened is MF Global -- we've
5 lost that trust factor involved in working with
6 futures, and the futures are about the only thing
7 we have to do this risk protection type of system.
8 So we got to look at something, and the
9 transparency that we're talking about in the FCMS
10 is a good thing. I think it's moving in the right
11 direction. But we have to continue to make sure
12 that it works for the smaller FCMS as well, who
13 works mostly with us in production agriculture.
14 So we have to watch it carefully. We don't over
15 regulate and increase costs so that it's a burden
16 going above and beyond where we're at on that.

17 As far as additional regulations, as I
18 said, we've got to be careful of the costs of
19 that, and the possibility of making sure that the
20 oversight by the DSR0 is there so that we know
21 what's going on and things are informed there.

22 One suggestion, and I'm going to throw

1 it out, that's been brought to me by producers is
2 the possibility of opting out of segregated fund
3 usage by the FCMS. We know there's going to be an
4 additional cost with that, but you're looking at
5 small people that can't afford any kind of losses
6 that are basically of -- went out and financed
7 their margins. So they're very, very concerned
8 about the loss of the margins as happened in the
9 MF Global situation.

10 So I'll throw that out as a possibility
11 just to think about that option.

12 MR. BARNETT: Well, thank you. I mean,
13 I think the big picture is that either whether you
14 have insurance or you have an alternative to
15 holding seg, that the point is the operational
16 risk that we're trying to address without those.
17 And without those, this overall package and the
18 need for disclosure and risk management -- but if
19 you change the equation, because you have an
20 alternative to holding seg or because you have
21 insurance, then it does change. It's like a
22 spreadsheet, you know, and it does change the

1 analysis.

2 But we're needing to move forward in a
3 sense with what we have. And we know that those
4 things in this Panel we're not addressing that,
5 but well aware of how James and your points about
6 insurance or an alternative to seg or something
7 like that would impact that analysis. So thank
8 you.

9 Michael?

10 MR. GREENBERGER: Yeah. I mean, I would
11 just say it's not opting out of seg. I think the
12 CFTC, going all the way back to 1936, has tried to
13 make it clear that you should not opt out of seg.
14 It's an open invitation.

15 I think probably what you're thinking is
16 if the FCM doesn't have to put it in a segregated
17 account, it can invest it much more profitably,
18 and, therefore, the cost to the FCM isn't as high.
19 But I will tell you, if you're telling an FCM that
20 they can put their hands on that money, you're
21 just -- it's an open invitation to theft. I think
22 it would be very, very counterproductive to have

1 --

2 MR. BARNETT: I think -- yeah, I think
3 when I hear the term given -- having watched the
4 discussions, I think about opting out of seg as a
5 colloquial term. And I think it is about how it's
6 held and who can access it. And some of the
7 systems are talking about the need to change the
8 code to make it work. And so it's not necessarily
9 --

10 MR. GREENBERGER: All right. I just --
11 I know that this has been discussed, but I just
12 think if we're talking about the FCM having free
13 access to the funds, co-mingling the funds or
14 anything of that sort, it's an open invitation to
15 more problems than we already have.

16 MR. BARNETT: Understood.

17 MR. GREENBERGER: And I am sympathetic
18 to the concern about the small FCMs, but I don't
19 know where you rank Peregrine in all this, but to
20 my mind it may be elitist. Peregrine was a small
21 FCM, and you can say, well, that was a one-off,
22 but to my mind, if you're going to be an FCM

1 whatever your size, you do have responsibilities
2 to protect customer funds.

3 Now I think we should be confident --
4 conscious rather of not overburdening the FCMS.
5 But I think these obligations are very, very
6 important. Going back to the shrinking retail
7 user of futures markets, I think MF Global is the
8 reason that the retail is shrinking. I think we
9 should try and be increasing retail.

10 If the commercials aren't hedging, the
11 ultimate consumer is at risk to volatile pricing
12 in the commodity, the benefit of hedging is
13 there's assured risk management of price, and that
14 benefits the consumer. And I think one of the
15 things that has driven the retail sector out is
16 the shock of MF Global and Peregrine. I think
17 there are other factors, but I don't think we
18 should give up on retail.

19 And that just brings me back to a point
20 I just want to make again. I mean, I think the
21 biggest protection to the loss of seg funds is the
22 investor being fully informed about the status of

1 the FCM. I agree we don't want bank runs, but we
2 do need enough information.

3 CFTC -- I don't know how many guys you
4 have now, but 700 guys looking over a \$300
5 trillion notional value market. It's comforting
6 to say all this information go to the CFTC, but I
7 think the only way the investor can be protected
8 is the market forces intelligently deciding which
9 FCM deserves the business. So I, again, would
10 like to see the CFTC get as much information as
11 possible in the SROs, but I really think the
12 investor is the ultimate protector of the system.

13 And by the way, the more information the
14 investor gets, the harder it is for the investor
15 to complain after the fact. So it cuts both ways.
16 It cuts both ways. All this information may be
17 available, but nobody may be looking at it.
18 Something goes wrong, and then they've had notice
19 of the problems, which puts them in a bad spot
20 trying to recover their funds.

21 The final thing I would say is Richard's
22 point about -- what I understand Richard to be

1 saying about the CFTC looking over data before
2 it's made public, is that would be the data that
3 you don't want to go to the public, not when we
4 decide what information the investor needs and
5 what information should be rightfully proprietary,
6 the CFTC shouldn't be holding on to the public's
7 information. That should be gotten out as soon as
8 possible.

9 It may be that one way around worrying
10 about proprietary data that Alessandro has talked
11 about and others is that that information goes
12 only to the CFTC -- I think that's right -- and
13 not to the public or the SROs maybe, too. I don't
14 know where you draw the line.

15 MR. BARNETT: Thank you.

16 MR. SEXTON: And I just want to make
17 sure that everybody is clear from our standpoint.
18 Today any type of investor, institution or retail,
19 can get information from NFA's website on seg
20 funds, seg fund investments, capital, whether or
21 not the capital is held in affiliate or not. And
22 that's available to anybody.

1 When I look at, though, some of the
2 requirements in 1.55(k)(10), which I think
3 Alessandro referenced earlier, I'm not sure when
4 you have a retail investor, whether or not that's
5 going to be clear and concise to that retail
6 investor as to what some of those factors are.
7 And that's the information that I would encourage
8 the Commission to think about making available
9 that the FCMs have an obligation to make available
10 upon request certain of that information, I think.
11 And certain of that information I think could
12 possibly just be disclosed to regulators in their
13 oversight and risk profiling of FCMs.

14 So I am not arguing that information
15 should not be available to retail participants.
16 By all means, we have done that for years. We
17 favor doing it on NFA's website where not only can
18 you review the financial information for FCMs, but
19 the disciplinary information also is all right
20 there in front of them. We have adopted a rule in
21 certain circumstances requiring certain of our
22 members, I think in the FOREX area, for example,

1 to, upon opening an account that customers should
2 be made aware of NFA's website and the basic
3 system. And then they have to provide that notice
4 once a year to all customers. We could certainly
5 think about doing that also depending on the type
6 of information that's available on our website if
7 that's the direction that the Commission wanted to
8 take and direct customers to our website. We
9 could do that for all members. I don't have an
10 issue with that.

11 So that's where we are as far as
12 disclosure today and where our special committee
13 has moved us from simply months ago and with
14 regard to many of these items that the Commission
15 is seeking to disclose today.

16 MR. BARNETT: Great. Thanks, Tom.
17 Grace.

18 MS. VOGEL: One concern that I'd like to
19 raise, if the required public disclosures are
20 proprietary and intrusive, we may return to the
21 day when the broker-dealer and the FCM were two
22 separate legal entities. And the concern there is

1 that the information you'll get on the FCM will be
2 public, but yet if another part of the
3 organization is in trouble, they're all going down
4 together. History has shown us that.

5 MR. BARNETT: Michael?

6 MR. GREENBERGER: As to that point, one
7 of the things I thought was very good about the
8 proposed rules, and I think it's embedded in the
9 statute -- I don't remember what provision in
10 terms of the responsibility of auditors -- is that
11 you're not just supposed to look at the FCM, but
12 you're supposed to look at corporate-wide
13 institutional affiliates on the theory that if the
14 affiliate goes down -- the FCM could be doing
15 everything correctly, but if the affiliate goes
16 down, the money can be gone like that.

17 And I do think your rules have a lot
18 embedded in them about the responsibility of
19 looking at affiliates, not just looking at the FCM
20 itself. So I applaud that. I think it's very
21 important. I know lots of situations where an FCM
22 is just doing fine, but an affiliate is tanking

1 and it brings the FCM down.

2 MR. COCCO: I wanted to agree with the
3 points that were made earlier by Grace and by
4 Michael, especially considering that in the
5 broader spectrum of Title 7, we may see some
6 consolidated market participants that are FCMS,
7 broker-dealers, swap dealers, all in one. And so
8 I think that it would make sense again to get the
9 calibration right, and it is all about the
10 specifics, as I was mentioning before, about
11 essentially K(10).

12 So getting the calibration right
13 encourages -- well, takes away a market distortion
14 that would encourage a further split into
15 different subsections to -- you know, if the rules
16 don't make a lot of sense. And so I think having
17 rational rules, which we're very close to with
18 this, that provide the adequate level of
19 disclosure for the adequate recipient is something
20 that should be applauded.

21 MR. BARNETT: Thank you. Go ahead.

22 MR. NUNERY: Yeah. I'd like to ask a

1 question about costs. Implicit in our
2 conversation thus far has been the idea that if
3 certain information is disclosed and it's
4 misunderstood by market participants, that could
5 create certain costs. And I'd like to better
6 understand what those costs might be, in part
7 because it seems to me that that's something
8 that's a potential risk with any information that
9 is disclosed. And so are there unique costs here
10 that we need to be cognizant of as we're trying to
11 balance these considerations?

12 MS. VOGEL: I think that, you know,
13 regulators are often in possession of information
14 that allows us to work with a firm and to move
15 customer accounts to a safer broker- dealer. So
16 we have various alert and early warning criteria.
17 Some of those criteria are based upon steady
18 deterioration in capital levels as a result of
19 losses or other risk taking. And we work with the
20 member firm that's a carrying and clearing firm to
21 either turn them into an introducing firm where
22 their customer assets are held by a stable

1 clearing firm, or their customer accounts are
2 transferred out to various firms over a period of
3 time. You know, our goal is for the customer
4 assets to be fully protected at all times.

5 What I'm concerned about with
6 information being out there publicly that may be
7 there -- we may not have adequate time to move the
8 customer assets to a safe home. And again, it's a
9 balance of getting the timing right and having
10 information available to investors.

11 MR. COCCO: I mean, I guess the cost in
12 terms of if you get it wrong, so, for instance, if
13 you -- I don't want to use a hyperbole, but if you
14 -- information gets out about liquidity, potential
15 problems with liquidity in a market dislocation,
16 of course lots of rumors run around. If you don't
17 manage that information process properly, the
18 rumor becomes reality even though there's no
19 substance to it. And so the cost would be the
20 death of a business and harm to customers.

21 So I think it's a pretty high cost if
22 you get it wrong, but the idea would be that if

1 there's a problem with liquidity, you talk about
2 it with regulators. If it's a real problem, you
3 get it resolved. You transfer positions to a
4 healthy FCM or to a number of healthy FCMs that
5 can take the volume. And that allows you to
6 provide an orderly liquidation of the business if
7 it's necessary, with keeping the public informed,
8 but at the appropriate time. So that would be an
9 example, in my view, of what the cost could be if
10 the process is not run in a way that is efficient.

11 MR. GREENBERGER: I'm very sensitive to
12 the cost benefit analyses that need to be done,
13 and I think the -- I must be candid with you. I
14 skimmed the cost benefit analysis, but it looked
15 to me to be extraordinarily thorough.

16 But the only thing I would say is, the
17 MF Global and Peregrine, you could argue was \$1.8
18 billion. Maybe that's all being adjusted now.
19 But let's say at its worst, \$1.8 billion loss of
20 customer funds. But the loss of confidence in the
21 futures market is a much, much higher figure.
22 This goes back to those who should be hedging are

1 not hedging. I haven't looked at the recent
2 statistics, but I know for a while the futures
3 business was down. I know at prior roundtables,
4 the buy side has threatened if these things happen
5 in the swaps, they're going to get out of the
6 swaps market.

7 So all I would say is I'd encourage that
8 a global cost analysis be done because MF Global
9 and Peregrine were a real slam to the head of the
10 futures market, I think unnecessarily so, and it's
11 an ultimate harm to the consumer. And I just hope
12 we do keep the global costs of customer funds
13 being lost in mind.

14 MR. COCCO: I just wanted to mention
15 that there are other areas of the rule where we
16 think that, you know, we have more constructive
17 comments that we'll be filing through a common
18 letter through the trade associations or
19 ourselves. So I just wanted to mention that in
20 the context of the cost analysis.

21 And I just think that it is tempting to
22 say, you know, we've had these defaults that have

1 caused these losses. But I think also there has
2 to be a measure. So, in other words, you have to
3 allow FCMS to conduct the business and to make
4 also a little bit of profit, which encourages
5 healthy risk management. In other words, we all
6 have our own thoughts on what the motivations for
7 humans are to perform the functions that they
8 perform, but you have to allow for a little bit of
9 an incentive to run the business in a safe and
10 sound manner.

11 So my point is that I would encourage to
12 continue in conducting an appropriate cost benefit
13 analysis, and that the support that we've
14 expressed for this particular part of the rule,
15 you know, and other parts of the rule, we have
16 more comments.

17 MR. BARNETT: Okay, thank you.

18 MR. THUM: I think as well, you know,
19 you think about costs, you know, do focus on the
20 benefits, you know. And the true benefits are
21 encouraging better behavior across the market. I
22 think as well, you know, the FCMS, some of them

1 are in this room, are FCMS. You know, we have
2 tremendous confidence in, and I think that the
3 story that they can tell through public disclosure
4 is a very strong one and a good one to hold up to
5 their peers.

6 So I think the benefit there is, you
7 know, take the light of day on the data and let
8 the customer see it. It will encourage FCMS that
9 perhaps have weaker practices either to tighten
10 their practices or get out of the business. And
11 the better FCMS will stand proud of the results
12 that they can show, and their clients will flock
13 to them. So I think there's benefits, and the
14 main benefit is much better behavior, and the
15 market moving where it should move ultimately to
16 the best FCMS.

17 MR. BARNETT: Great, thank you.
18 Anything else before we close?

19 MR. HORGAN: Just on the cost item, I
20 think it is something that was done very well
21 within the proposed rules. I believe the primary
22 cost is going to be additional staffing

1 requirements that are going to be borne by the
2 regulators and the FCMs, and that cost has to be
3 factored into the services provided. So if you
4 look at the analysis on implementing these
5 requirements, it is going to require additional
6 staffing, and that staffing has to be considered
7 when managing the business.

8 MR. BARNETT: Thank you. Bill.

9 MR. TIRRELL: The one point I think I
10 want to make here, too, is that if you look at the
11 -- and we talked about cost benefit. But I think
12 we have to look at the proposed regulation
13 holistically because when you add up all the
14 different factors involved, the greater
15 transparency, the daily flow of information that
16 did not exist, the better tools that are coming
17 out of the NFA and the CME on a daily oversight,
18 periodic inspections. Again, put all those
19 together, I think that builds a lot of confidence
20 in the industry and in the clients.

21 And I think the balancing part of that
22 is -- I really believe that you should err on the

1 side of not disclosing information, let it evolve
2 a little bit because all these other oversights,
3 all these other reporting requirements, all the
4 early warning you're putting in there is
5 providing, I think, a lot of confidence to our
6 clients. And, you know, we would hate to have all
7 that taken away because we were a little
8 aggressive in what we disclosed, and it got
9 misunderstood, and you revert back to that level
10 of lack of confidence or questioning the rules and
11 regulations and the oversight.

12 So there is a lot that is being
13 comprehended within these proposals. There's a
14 lot of work that the FCMs need to do in order to
15 be compliant. And I think the reality is that
16 other than two bad apples, the industry has a very
17 good history of being compliant, and providing,
18 you know, information to our clients, and
19 providing, you know, good controls and so on. Can
20 we do things better? Of course we could, all
21 right?

22 But I think if you look at the size and

1 the breadth of most of the FCMS, they're highly
2 regulated. Most of them are dually registered as
3 broker-dealers and FCMS, and they have a
4 tremendous amount of oversight. A lot of the
5 larger ones are under bank holding companies. So
6 we do have the alphabet soup of every regulator in
7 the world looking at us. So I think there's a lot
8 -- and a lot of disclosures that go along with
9 that.

10 So I would just suggest to you that we
11 need to take a much more holistic approach to
12 these issues, and although we're having these
13 panel discussions on very, you know, focused and
14 segmented items, I really do think that you have
15 to start taking a much more holistic approach,
16 because this is something that weighs very
17 heavily, I think, on the FCMS and could actually
18 work against you in the long run.

19 MR. BARNETT: Thank you, Bill. Anything
20 else? All right. Well, thank you all very, very
21 much. We really appreciate it. Thank you.

22 (Recess)

1 (Recess)

2 Third Session - Requirements for Segregation and
3 Secured Acknowledgement Letters

4 MR. BARNETT: Okay, we'll get started.

5 Welcome back to the staff's public roundtable on
6 selected issues or topics included in the
7 Commission's customer protection rulemaking. We
8 move now into our third topic, looking at issues
9 that have been raised on the Commission's proposal
10 for bank and custodial seg and secured
11 acknowledgment letters.

12 In terms of housekeeping items, this
13 session will go from now until 3:15, then we'll
14 take a 15-minute break before we start the last
15 session of the day. And as we said at the
16 beginning of the overall roundtable in our
17 discussions, any of the staff people up here may
18 express views and thoughts on various topics.
19 That person's views and thoughts are those of that
20 individual, not those of the Commission, any of
21 the commissioners, any division, or any other
22 staff.

1 So, now to get our second session
2 started, let's thank our panelists -- thank you --
3 on this one, and let's quickly go around the room
4 with each person stating name and company
5 affiliation.

6 Ron?

7 MR. FILLER: Ronald Filler, New York Law
8 School.

9 MR. GREENBERGER: Michael Greenberger,
10 University of Maryland Law School.

11 MR. MURPHY: Kevin Murphy, Barclays
12 Bank.

13 MR. FERRIS: Scott Ferris, BMO Harris
14 Bank.

15 MR. WOLF: Doug Wolf, National Pork
16 Producers Council.

17 MS. TAYLOR: Kim Taylor, CME Group.

18 MR. SEXTON: Tom Sexton, National
19 Futures Association.

20 MR. ROE: John Roe on behalf of the
21 Commodity Customer Coalition.

22 MR. KEMP: Todd Kemp, National Grain and

1 Feed Association.

2 MR. NUNERY: Cam Nunery, Office of the
3 Chief Economist at the CFTC.

4 MR. SMITH: Tom Smith, DSIO.

5 MS. DIETZ: Phyllis Dietz, Division of
6 Clearing and Risk.

7 MR. BARNETT: Gary Barnett, DSIO.

8 MR. PICCOLI: Kevin Piccoli, DSIO.

9 MR. BARNETT: Now, just a very brief
10 introduction. This acknowledgment letter that
11 we're going to talk about has a lot of history to
12 it, and it raises issues in at least two of our
13 divisions, DSIO and DCR, and we've had, recently,
14 meetings with the industry and the banks about
15 focusing largely on the examination need to orally
16 confirm account balances and to obtain online
17 read- only access to a firm's accounts. I think
18 those issues have been largely vetted, though the
19 floor is open to let participants state their
20 views on that score.

21 But there were other issues that have
22 not been as well vetted, and we want to focus on

1 those issues in today's discussion, and we thought
2 that to set the stage for that discussion -- you
3 will raise those issues and talk about them --
4 that Phyllis Dietz of DCR is going to give us an
5 overview of the history of the acknowledgement
6 letter and its issues and probably take the lead
7 on the discussion of those other issues. So, with
8 that I'm going to turn it over to Phyllis.

9 MS. DIETZ: Thank you. This issue has
10 been percolating since 2009. We have had, now,
11 three proposals, and to just walk you through to
12 refresh your recollection as to how we got to
13 where we are today, in February of 2009 the
14 Division of Clearing and Intermediary Oversight --
15 a blessed memory -- proposed certain revisions to
16 the acknowledgement letter requirements, and this
17 was based on the view -- and I will read you the
18 language -- that the acknowledgment letters were
19 required to state that the depository understood,
20 acknowledged that the customer funds were being
21 held in accordance with the provisions of the
22 Commodity Exchange Act and CFTC regulations. And

1 while that seems very straightforward, it was
2 apparent that not everybody understood exactly
3 what that meant. People recited that and signed
4 onto it, but it lacked a certain detail, and
5 different people understood it to mean different
6 things. So, the impetus for the initial proposed
7 amendments was basically just to clarify what we
8 understood it meant, what we intended it to mean,
9 and hopefully to ensure that everybody else who
10 was signing these agreements agreed with us as to
11 what it meant. We were looking for consensus and
12 understanding.

13 After we received comments, among the
14 comments was the suggestion -- and this was the
15 FIA, and Barbara's here, she remembers that -- the
16 FIA said how about a form letter? Could we have a
17 template? And then it's very clear as to what the
18 rights and obligations are. We have a level
19 playing field. And we can also simplify the
20 process of getting these acknowledgment letters
21 signed, because we can shortcut negotiations.
22 Here's the required letter. Everybody agrees to

1 the same thing, because presumably compliance with
2 the Act and Commission regulations means the same
3 thing for everybody.

4 So, with the assistance of the FIA, we
5 did develop a proposed form letter, template
6 letter, and then we re-proposed. So, the
7 re-proposal then generated comments, and the
8 re-proposal was in August of 2010, and we got the
9 comments back, and then through a series of
10 events, not the least of which was Dodd-Frank
11 rulemaking, this project was delayed somewhat.
12 And more recent events rekindled an interest in
13 pursuing these amendments and enhancing
14 understanding. And in addition to the original
15 goal, which was just to make sure everybody
16 understood what the rights and obligations were,
17 there were additional requirements that, in light
18 of Peregrine and MF Global, people said we need to
19 take a look at additional procedures -- it's not
20 just the Act and Commission regulations. Should
21 the acknowledgment letter be a vehicle for
22 imposing other requirements and establishing other

1 procedures to further customer protections?

2 So, the most recent proposal -- and the
3 comment period is, still we have a few more days
4 left -- added some additional provisions,
5 requirements, the read-only access. It restates
6 certain other provisions like immediate release of
7 funds. And I know we've gotten comments on that,
8 questions about not only some of the procedures,
9 like immediate release, but some of the drafting
10 and terminology, taking reasonable measures to
11 ensure that the instructions are properly given,
12 what are proper instructions, what procedures
13 should be followed to authenticate instructions
14 for release of funds, et cetera et cetera.

15 So, we have some old issues that we're
16 prepared to revisit, and then we have some new
17 issues that we'd like to hear more about. So, I
18 think that for now the purpose of this discussion
19 is to raise some of these issues and get some
20 commentary from the different sectors represented
21 here. It's easy enough to send a comment letter
22 in, but the comment letter is just your comments,

1 and sometimes it's helpful for us to have a
2 give-and-take among our guests here today so that
3 we can better able sort through the pros and cons,
4 pluses and minuses.

5 The purpose isn't so much to answer your
6 questions or to come to a conclusion today. I
7 mean, that's not really appropriate. But we do
8 want to get your input. We want to be able to ask
9 questions and ask for your suggestions to the
10 extent you have complaints about drafting or
11 language or you don't like "immediate" as a term.
12 We're open to hearing what you might suggest
13 either today or in a comment letter, because that
14 assists us. I mean, we have some ideas as well,
15 but for today it's more important for us to hear
16 your ideas than you to hear us.

17 So, with that we can sort of go around,
18 if you would like, and just get initial comments
19 and then comments back and forth or particular
20 topics that we can just start.

21 Ron, if you want to start.

22 MR. FILLER: Glad to. Thank you very

1 much. So, I chaired the FIA committee back in '09
2 when you had the proposal, and I worked closely
3 with Phyllis and her team as we were deciding what
4 the final acknowledgment letter should be, and
5 before that when I was at Lehman I signed probably
6 some 60 or 70 acknowledgment letters, so I think
7 that one of the important things is that whatever
8 you find the rules will be, the acknowledgment
9 letters should not be permitted to be changed. I
10 mean, they should be uniform, final letters,
11 because you don't want a bunch of FCMs in a
12 custodial or depositories or whatever trying to
13 negotiate.

14 The second thing is, and more difficult,
15 when you say it should be a uniform acknowledgment
16 letter is when you deal with firms outside the
17 U.S. They just have a different approach, they
18 have different procedures, and you have a US FCM,
19 which will have customer accounts in all the major
20 exchanges around the world. Under Part 30 regime,
21 you've got to be very careful. Again, to me it
22 should be a uniform statement. But you've got to

1 be very delicate, because some of them -- and
2 given their laws over there, on the bankruptcy
3 laws they are so different that the meaningful
4 purpose behind the acknowledgment letter doesn't
5 always live. And what we learned with Lehman even
6 four and a half- plus years later, some of the
7 funds are still "frozen," notwithstanding the
8 acknowledgment letter. But that's a different
9 issue than what you're talking about here. So, to
10 me it's a need for dealing with -- whatever the
11 acknowledgment letter is, it should be
12 standardized and uniform.

13 And the other thing, you know, is if you
14 think about it, under 1.25 an FCM may have
15 investments with 30 or 40 money market funds or
16 other permissible investments, and you've got to
17 make sure that those acknowledgment letters --
18 now, whether you need a special acknowledgment
19 letter for a money market fund and a separate one
20 for a bank, custodial bank, that's fine -- I mean,
21 whatever the comments might be -- but all money
22 market funds and all the bank ones should be

1 pretty much standardized.

2 MR. GREENBERGER: I'll make some
3 preliminary remarks.

4 One thing that you implied but didn't
5 state directly was that there was not an
6 understanding of what it meant to be in compliance
7 with the CEA and the regulations. My
8 understanding had always been that the principal
9 purpose of the acknowledgment letter was that the
10 money being transferred through the FCM if in
11 segregation would remain in segregation in the
12 depository. Was there ever any confusion about
13 that when you say nobody knew what it meant to be
14 in compliance?

15 MS. DIETZ: I don't think there was
16 confusion about the concept of segregation --

17 MR. GREENBERGER: By the depository.

18 MS. DIETZ: -- by the depository. But
19 there were certain situations where it was not
20 clear how that principle was applied.

21 MR. GREENBERGER: All right, because
22 from my experience I thought that that was a

1 guarantee -- this is another question -- guarantee
2 to the customer that when the FCM deposits the
3 money, it would stay in segregation when and where
4 it was deposited and the acknowledgment letter was
5 evidence that that was going to happen. In all of
6 the disclosure we've discussed I've lost track of,
7 does -- in the new regime, proposed regime does
8 the customer have access to the acknowledgment
9 letter?

10 MR. SMITH: Under the proposal, the
11 customer does not. The customer does not have
12 access to the acknowledgment letter.

13 MR. GREENBERGER: I think customers are
14 very confused. I mean, I say this because I
15 mostly talk to retail customers and not in any
16 professional capacity but hear their complaints.
17 They don't know what an acknowledgment letter is.
18 They don't know in a sense that's an audit trail
19 of where the money has gone and that it's an audit
20 trail to ensure that it continues to be
21 segregated. It seems to me the customer ought to
22 be -- I don't know what the harm would be for the

1 FCM to either --

2 MR. SMITH: I think, though, one of the
3 things that may mitigate against that is it would
4 be a standard form template that would be set
5 forth in the rules. And then in addition to that,
6 through what we have proposed here the Commission
7 has -- and the NFA existing rules -- you will know
8 who all the depositories are for any particular
9 FCM. So, you would have a way of seeing what is
10 the standard form language, and particularly, as
11 Ron said, the rule was that it could not be
12 altered at all, it had to follow that. And you
13 would also know who the depositories are.

14 MR. GREENBERGER: I am completely in
15 support of the standardized form, and I agree with
16 everything about that and that it should be final
17 and that you have issues about merger clauses. I
18 think your proposed resolution is very good. The
19 question is that you may know an FCM has 20
20 depositories, but you don't know where your money
21 is deposited.

22 MR. SMITH: Well, I think that raises a

1 separate question, because your money is
2 collectively all the customers' money. So, you
3 put in a certain amount of money. You can't
4 necessarily -- you can't at all pick which
5 depository you want it to go to.

6 MR. GREENBERGER: No, I'm not saying you
7 pick, but you may have a point. I just want to
8 see if I understand it. All I'm saying is from my
9 experience, the customer never knows which
10 institution has ended up holding his segregated
11 funds or her segregated funds. I'm not saying
12 they should choose it or anything else.

13 MR. SMITH: Right.

14 MR. GREENBERGER: But it seems to me
15 that's an important piece of information.

16 MR. SMITH: Yeah, and I think what --
17 under the proposal and under the NFA rules you
18 will know all of the depositories for a particular
19 FCM holding 4D segregated funds, and your money is
20 comingled, or the customers' funds are comingled.

21 MR. GREENBERGER: So, Tom is what you're
22 saying is you can't trace where your money is,

1 because it's comingled?

2 MR. SMITH: That is correct.

3 MR. GREENBERGER: Okay. That's fair
4 enough. Otherwise, I completely agree with what
5 is said about the necessity for standardized
6 forms, finalized forms. To me, the acknowledgment
7 letter is an audit trail. It's a clear indication
8 of where segregated funds are located.

9 The point that I comment this from is
10 money is transferred -- segregated funds are
11 transferred into an unsegregated account. Now,
12 there's -- well, when they're transferred -- let
13 me say this. There should be three reasons that
14 the segregated funds are transferred: They're put
15 in a depository, either domestic or foreign, and
16 they comply with all those rules; or it's a 30.7
17 secured transaction that is deposited.

18 Where I have seen a lot of people get
19 lost is they don't know anything about the
20 acknowledgment letters, but the FCM takes the
21 position that in an oral discussion the customer
22 has authorized the money to go out of segregation

1 into, say, for example, an affiliated institution
2 and therefore for an investment, and therefore it
3 is now no longer segregated. There is a
4 regulation 86.2, interpretation of 86-2 -- that --
5 I think it was then the Division of Trading and
6 Markets came out with it -- said, well, if a
7 customer wants to take his money out of
8 segregation to invest it, which is a perfectly
9 permissible thing to do, there have to be very
10 clear forms that explain that.

11 There are five hypotheticals that are
12 given, but the message that was sent is you have
13 to have a written request to the FCM saying that
14 the money be transferred to a specific account
15 that is held in the customer's name and an
16 acknowledgment that it will no longer be
17 segregated. What I'm hearing is that a lot of
18 confusion over where money went comes over oral
19 conversations that were had between the investor
20 and the FCM where the FCM takes the position that
21 the customer has agreed, for example, to put the
22 money in an affiliate for some kind of investment

1 and it no longer retains segregation. That's fine
2 that it doesn't, but the customer has got to
3 understand that, and I think that's a weakness in
4 the system.

5 MR. SMITH: I think there's a
6 distinction that could be drawn between a request
7 by a customer to move money where the customer
8 says I want to move my funds from a futures
9 trading account to a securities investment account
10 either at a dual registrant or to another broker
11 dealer that's an affiliate or even an unaffiliated
12 entity and that, you know, there will be a
13 communication between -- or should be -- between
14 the customer and the FCM regarding that. If the
15 FCM chooses on its own to take customer funds and
16 invest them as they're permitted under 1.25, there
17 has to be -- if any cash goes out of the 4D seg
18 account, there has to be a corresponding receipt
19 of 1.25 permitted collateral, so the segregated
20 total shouldn't be changed at all.

21 MR. GREENBERGER: Yeah, let me just say
22 I'm not talking at 1.25. I'm talking about the

1 FCM believing it has instructions from the
2 customer, and a lot of times you know that it goes
3 from, let's say, blank FCM or blank FCM to blank
4 capital markets. It's an affiliate, so the
5 customer sees the same name, sometimes the same
6 address, sometimes the same floor at the same
7 address and thinks, oh, my money has just moved,
8 my segregated funds have just moved to a thing and
9 they don't understand that the FCM has a position
10 that somehow the customer authorized that.

11 Sometimes it's very easy. The FCM can
12 say we're going to put it in our affiliate, and
13 the affiliate is an unsegregated account for other
14 purposes of investment, and the customer does not
15 understand the significance of that.

16 86-2, which is sort of I think lost in
17 memory, says yeah, there are effectively three
18 situations if the money moves. There's an
19 acknowledgment letter to a depository for
20 segregated; there's an acknowledgment letter to a
21 depository for 30.7; and if it's not a depository
22 but a customer-driven investment -- not 1.25 done

1 by the FCM -- well, okay, then you have a letter
2 that's mandated by 86-2, which is a written
3 direction from the customer to send the money,
4 because I have seen lots of confusion out there
5 where the money is moved to what seems like the
6 FCM but to an affiliate, and the position is taken
7 that the customer authorized that.

8 MR. BARNETT: Let me try -- let me
9 change the fact pattern a little bit. So, FCM
10 puts customer funds into 4D and then puts in
11 excess -- puts in its target residual or something
12 and then for some reason decides to withdraw some
13 of its funds.

14 MR. GREENBERGER: Who is withdrawing
15 funds?

16 MR. BARNETT: The FCM. The FCM is going
17 to --

18 MR. GREENBERGER: Yeah.

19 MR. BARNETT: -- it can withdraw some of
20 its funds. Does the depository -- what are you
21 suggesting, that the depository know whether it's
22 excess funds or customer funds that are being

1 withdrawn? Would 86 whatever the letter is --

2 MR. GREENBERGER: No, 86-2 is not -- is
3 a -- look, everybody agrees that a customer has
4 the right to take his money and use it for other
5 investment purposes or take it back. Where there
6 is a lot of confusion I see in the small futures
7 market is that an FCM will tell the customers
8 something like, is it all right with you if we
9 move it to our affiliated company that has a
10 similar name, is on the same floor, same building;
11 the customer says yes, and they say, aha, that's
12 the authorization from the customer not to keep
13 the money segregated. So, there's a fight and a
14 dispute. 86.2 says we shouldn't have those
15 fights, because there should be a written document
16 that the customer signs instructing the FCM I want
17 to move my money to X. And if the customer signs
18 that -- and in 86-2, the Commission says the
19 signed document by the customer taking his or her
20 own money out of seg and saying where it is going
21 to go, if it meets this format, will end disputes
22 over whether the customer has orally authorized

1 something to happen.

2 MR. BARNETT: Okay, so can I -- I'm
3 going to read -- so, you're talking about a
4 situation. We're not talking about going under
5 seg rules. We're talking about funds that are
6 buffer from the customer's perspective and they
7 want to take some of the buffer out. And they're
8 being sort of -- "convinced" is the wrong term,
9 but, you know, move it from here to something else
10 that goes on with an affiliate with the FCM. But
11 it's totally permissible to come out of seg. The
12 problem is that the customer may think they're
13 still subject to the protections of seg is what
14 you're getting at.

15 MR. GREENBERGER: Yes.

16 MR. BARNETT: And that you're saying
17 that if that's happening, if the buffer is being
18 pulled out and going to an affiliate somewhere and
19 the customer may be misled about whether
20 protections are still in place, you think that
21 withdrawal should be documented.

22 MR. GREENBERGER: Yeah, because I think

1 the auditors -- if the money was originally put in
2 seg and it's not seg, the auditors have three
3 vehicles that are helpful to them.

4 MR. BARNETT: Mm-hmm.

5 MR. GREENBERGER: One is if it's in a
6 depository, they've got an acknowledgment letter.
7 It's still segregated. If it's 30.7, they've got
8 a 30.7 acknowledgment letter. But if the customer
9 has decided, of his own accord, that the money
10 should be moved somewhere, then they have
11 something that I think is still required by 86 --

12 MR. BARNETT: And how would that -- just
13 so I get that part -- how would it impact the
14 custodian? Does it impact the custodian at all?
15 Not in this discussion, right?

16 MR. GREENBERGER: No, no, because the
17 customer --

18 MR. BARNETT: It's a totally separate
19 issue.

20 MR. GREENBERGER: Yeah, the customer.

21 MR. BARNETT: Okay.

22 MR. GREENBERGER: If the money is in

1 deposit, the customer is saying to the FCM I want

2 --

3 MR. BARNETT: Custodian can't know.

4 MR. GREENBERGER: What?

5 MR. BARNETT: The custodian can't be
6 monitoring --

7 MR. GREENBERGER: Yeah, but the question
8 is -- and I've seen this far too often -- that
9 somehow the customer is told by the FCM, oh, when
10 we said we were going to move it from X to Y, you
11 understood that was no longer going to be
12 segregated.

13 MR. BARNETT: Right, right. Okay.

14 MR. GREENBERGER: 86-2 -- I mean, I
15 don't know where it stands, and I know it may not
16 be where your focus is, but as I see it, if you
17 want auditors to be able to track down what
18 happened to segregated funds, the initial step
19 could be as simple as threefold, not the final
20 step. There's either an acknowledgment letter
21 that it's going to a depository, or if it's a 30.7
22 to a 30.7 depository, or the money isn't

1 segregated, no acknowledgment letters, okay, then
2 we've got to look for the customer's instructions
3 to move the money somewhere else.

4 MR. BARNETT: Okay. And, Ron, go ahead.

5 MR. FILLER: Okay. I just want to
6 provide a little history behind Michael's -- in
7 2005 we already have this matter litigated.
8 Refco, when they went under, had a lot of
9 commodity pools as customers, and Refco
10 encouraged, enticed, whatever, because the pools
11 had excess margins sitting with the FCM to move
12 the equity over to Refco capital markets, which
13 was not an FCM, and when Refco and Refco capital
14 markets all went under in 2005, some of the
15 investors thought their "money was protected" as
16 seg Refco capital markets, but they were not and
17 they became unsecured creditors. And pretty much
18 since then very few customers today leave excess
19 monies equity with an FCM; and, too, with your new
20 gross margin role that took effect -- well, not
21 November, December I guess now -- you know, very
22 little money or less money sitting with the FCM,

1 and almost most of the money now is sitting at the
2 DCO because of the gross margin rule. Yes, it can
3 happen, but it's not happening on a practical
4 basis today.

5 MR. GREENBERGER: Well, let me just say
6 the Refco thing is in litigation in the southern
7 district of New York, and this issue was alive on
8 there.

9 MR. BARNETT: Okay. Now, we need to go
10 --

11 MR. GREENBERGER: Yeah, I would just say
12 that -- it's not enough to say, well, nobody's
13 leaving excess margin anymore. Are the FCMs happy
14 that they're not leaving an excess margin? And
15 isn't that part of the customer's moving away from
16 the futures market?

17 MR. BARNETT: Yeah. There are other
18 scenarios where consumers of various sorts of FCMs
19 or BDs can think they're customers when they may
20 not be, and the SEC issued a no-action letter
21 December 10th to FINRA on this topic. Different
22 fact pattern but the same kinds of concerns about

1 somebody may claim or believe that they're
2 protected. There's a letter out there that just
3 came out.

4 But let's go back to -- yeah, let's go
5 back to the bank issues, and I know that when we
6 left the discussion a week or two ago with
7 industry, we received a list of issues, and it
8 would be great if somebody could start to bring
9 those issues out and talk about your views on
10 them.

11 MR. MURPHY: Sure. I was -- my name is
12 Kevin Murphy. I'm at Barclays now, and three
13 years ago I worked with Ron in a broader group on
14 the first, you know, attempt to put in place an
15 industry standard seg letter. And I think, you
16 know, my philosophy is that I like the idea of
17 having a standard letter. It would be nice not to
18 have to negotiate with FCMS, you know, all the
19 proposed letters that are presented to us, which
20 is something heretofore we have had to do.

21 But I think it's important that the
22 contents of the letter reflect as best as they can

1 the way banks process transactions. And a couple
2 of points that I know we've spent time with you,
3 Gary, and Kevin and some others describing some of
4 the things that stand out. The notion that the
5 CFTC would like read-only access to the accounts
6 -- I think the banks that have gathered together
7 to look at your proposal for a letter are
8 generally supportive of that notion as long as the
9 channel by which we communicate with the CFTC is
10 an authenticated means and that it's practical to
11 implement. I think, you know, what we've
12 explained to you is that some of the wholesale
13 systems banks used to provide information to the
14 FCM community are -- they're not necessarily user
15 friendly. You know, passwords expire frequently;
16 there's physical security in the form of RSA
17 tokens. And we can do what you ask, I believe, if
18 we take it literally, but I'm fearful it will be
19 very difficult to implement as a practical matter.
20 So, we need to work on that. But you've heard
21 those thoughts.

22 On the issue of immediate release of

1 funds, I think the same issues apply. You know,
2 we could process outgoing payments initiated by
3 the CFTC, you know, out of an FCM bank account.
4 But, again, we would want to make sure that the
5 channel is authenticated, which is a standard that
6 banks need to adhere to with our regulators. And
7 the immediacy standard is difficult. I could say
8 that, you know, the bank I work for now -- we
9 don't meet that standard with our clients. I
10 think it's a service level we strive to get to,
11 but we never will. So, the semantics of that I
12 just think need to reflect the reality of how we
13 process payments.

14 You introduced an issue of, you know, a
15 new liability standard in the document, which, you
16 know, where the banks effectively need to know
17 when they process outgoing payments on behalf of
18 an FCM that they're effectively compliant, that
19 the payments themselves are compliant with the
20 act. And I think our fear is that that due
21 diligence standard will slow our processing to a
22 point where it just won't work for the industry,

1 and it will certainly not be immediate so it flies
2 in the face of your earlier requirement.

3 And then finally, the no-lien
4 provisions. We've made some progress since the
5 initial draft of the letter, which we worked on in
6 '09 I think. You know, some of the sort of
7 operating mechanics, you know, just don't work
8 with that, like an example that you were very
9 cooperative with earlier was building in the
10 notion that we can return bounced checks that are
11 deposited to the account. That was very useful.
12 There are some other things we'd like to see
13 provided for, like we're often faced with
14 situations where an FCM will have clients
15 requesting to pull funds out of the account, but
16 investments need to be liquidated to fund the
17 operating checking account before we can process
18 it as outgoing payments, and I think the banks
19 have been operating with the view that if there
20 are multiple seg accounts -- you know, 4d accounts
21 -- open on the books of a bank, they might be in
22 the custody accounts. You know, custody accounts

1 hold them in long securities positions, repo
2 collateral, that we can sort of look at the
3 accounts as a group and process a payment out of a
4 checking account, creating an intraday overdraft
5 in anticipation of liquidating an investment. If
6 we didn't have the ability to do that, it would
7 create an increased reliance on intraday credit,
8 and the clients would end up suffering I think.
9 Did I mess it up?

10 MS. DIETZ: Let me just clarify. In a
11 situation like the overdraft situation you've
12 described, there is value in the customer account.
13 It just might be in the form of securities that
14 have to be liquidated, is that correct? So the --

15 MR. MURPHY: Well, you have to be
16 careful how you define "account" --

17 MS. DIETZ: Okay.

18 MR. MURPHY: -- because I think the way
19 we operate today is we execute separate
20 acknowledgment letters for every account, right?
21 So, there might be a custody account, multiple
22 checking accounts, a money market fund account

1 with the asset management arm of the bank. So,
2 each of those accounts would have its own
3 acknowledgment letter, and each of them -- you
4 know, in the proposed form, each of them would
5 state the bank. You know, they can't rely on the
6 assets of that account as a form of offset against
7 some other liability, and so that's what presents
8 the problem.

9 MS. DIETZ: And so the overdraft is
10 actually an extension of credit then, and it's an
11 extension of credit -- to whom, do you consider?

12 MR. MURPHY: That's the issue. Is it on
13 behalf of the clients collectively, or is it on
14 behalf of the FCM? So, if Kim Taylor's clearing
15 house were to call an FCM for variation margin,
16 asking the bank to debit the operating customer
17 segregated funds account, the bank might be
18 inclined to process that transaction knowing that
19 there are, you know, long assets in a money market
20 mutual fund where we've signed the acknowledgment
21 letter. Or there might be a repo collateral
22 sitting in a custody account where the FCM will

1 even instruct us that they're going to liquidate
2 those funds to fund the operating account, you
3 know, inducing us to process Kim's settlement.
4 But if we can't do that, if we can't operate that
5 way, then it will create -- you know, we'll have
6 to underwrite that exposure with additional
7 intraday lines. It might make it harder to bank
8 some of the smaller firms in the industry. Firms
9 might have to require their clients to leave more
10 prefunding in anticipation of these flows.

11 MR. FERRIS: I think -- if I can just
12 maybe add on to what Kevin said, I think there are
13 a couple of points here that, you know, in the
14 course of transaction processing, you know, during
15 the day, there are ebbs and flows of funds coming
16 in/coming out. To the question you asked -- you
17 said, well, are there always assets in the bank
18 that offset the overdraft it's created? At times
19 there are and at other times it may be simply a
20 timing mismatch of payments coming in. So, for
21 any given FCM during, for example, the afternoon
22 variation cycle, that FCM will have winners and

1 losers. The winners will want their money, and
2 the FCM will begin processing outgoing payments to
3 pay the customers that were in a collect position.
4 And they're calling for margin from the clients
5 that were needing to pay for their variation
6 margin. And so in the simple timing flow of that,
7 you could have overdrafts created or the bank may
8 permit overdrafts to be created with the
9 understanding that as that variation cycle occurs
10 and whether that money is coming from customers,
11 coming from an exchange, coming from investments,
12 you know, there's a degree of just providing
13 liquidity into the system to allow payments to
14 flow and clients to receive money and be able to
15 fund their accounts in a timely manner and keep
16 the system sort of moving within reasonable
17 parameters for each FCM. Yeah, I think
18 importantly, you know, and if you think -- and
19 Kevin touched on this -- the interpretation as
20 written here is that, you know, a bank, you know,
21 would not be able to look to offset, you know, for
22 overdrafts created for the benefit of the

1 customers, for the customer accounts, if we're not
2 able to recover from the customer account for any
3 advances made during the day that effectively
4 create the requirement to prefund. And so that
5 then will, you know, likely cause the FCM to cause
6 its clients to prefund, and if you think about,
7 you know, the businesses that are maybe served by,
8 you know, the Grain Association or the Pork, they
9 have financing arrangements that sit behind that
10 that are often driven by, you know, their
11 underlying customers' positions, and so, you know,
12 their ability to put money up to prefund may be
13 difficult and their ability to access their
14 financing arrangements ahead of sort of market
15 moves may be also very difficult. So, there's
16 truly a ripple effect.

17 But to be clear, I mean, the banks can,
18 you know, sort of, you know, follow the letter of
19 the law as it's written here and not allow an
20 overdraft in the account. But I think that that
21 operationally just makes the entire system slow
22 down and often in cases the clients are going to

1 suffer from, you know, needing to have more
2 capital, you know, and liquidity placed with the
3 FCMs and waiting longer to receive their funds as
4 a result of that.

5 MS. DIETZ: Yeah.

6 MS. TAYLOR: I think we also place at
7 risk the chances that there will be inappropriate
8 failures to pay clearing houses -- so, technical
9 failures to pay clearing houses that could
10 actually be fatal to a clearing member, because if
11 you don't pay the clearing house the settlements
12 that are owed, generally speaking that triggers
13 the ability for the clearing house to put the firm
14 in default, which we certainly would not want to
15 do if it were not truly the case that the firm was
16 in default. But if the clearing house is not
17 going to get paid, I don't know of a clearing
18 house that that doesn't trigger -- that's not one
19 of the conditions that triggers their default.

20 And what Scott said about the financing
21 arrangements -- my understanding is that for at
22 least agricultural commercial hedgers, it's very,

1 very likely the lending arrangements that they
2 have with their financing banks require
3 presentation of a statement from the FCM that has
4 the margin call information on it in order for the
5 financing to be released and in order for the
6 margin call to be funded. So, it is very
7 difficult, under those circumstances, for the
8 clients to prepay.

9 MS. DIETZ: And I think one of the
10 issues that the staff has grappled with is Section
11 4d and the limitations on, you know, the use of
12 customer property. And I think we all welcome a
13 solid legal analysis that could help us out,
14 because right now when the clearing house has to
15 be paid, it's really the obligation of the FCM to
16 make the payment. There's a privity of contract
17 between the FCM and the clearing house. So, one
18 slightly different perspective on this situation
19 is the money that's owed is money that the FCM
20 owes on behalf of its customers, but if you're
21 going to put a lien on something, put a lien on
22 something that belongs -- an asset that's the

1 FCM's, because it's really an advance for the
2 benefit of the FCM acting on behalf of its
3 customers. And that's what we are trying to deal
4 with here. Nobody wants to stop, you know, the
5 flow of funds. Everybody wants the clearing house
6 to get paid. But if you're not supposed to take a
7 lien on customer funds, where can the depository
8 get legitimate comfort? And I think they can get
9 it from the FCM. And I think that's, you know,
10 the issue we're trying to get straightened out,
11 and that's the genesis of this prohibition on the
12 lien, because you're not supposed to put a lien on
13 customer funds for an advance that you're making
14 to the FCM to fulfill the obligation that the FCM
15 has to the clearing house. But if there's a
16 different way of looking at this, you know, a
17 different analytical model, you know, we need to
18 evaluate that and sort of get through that and
19 come to an understanding of whose responsibilities
20 go to what. So, but yeah, nobody wants --
21 certainly we don't want -- the clearing house not
22 to get paid. But I think that's what we're

1 struggling with - is the letter of the law -- and
2 trying to figure out how these practices square
3 with the legal standard. So, again, I encourage
4 anyone, you know, in your comment letters to give
5 thoughtful legal analysis, because that will be
6 very helpful to the staff.

7 Other thoughts about the lien issue, and
8 are there other circumstances where this comes up?
9 You've talked about variation payments. One
10 question I have is just to clarify, so you start
11 processing payments before all the collections
12 come in. So, there's not necessarily a sequence.
13 We get all the money and then we pay it out, is
14 that correct?

15 MR. MURPHY: We can't, because there are
16 certain sort of rigid timing conventions in the
17 industry, like, you know, for instance, you know,
18 the FCM community, as you guys know well, invest
19 the client money in a number of vehicles -- repo,
20 U.S. government securities, money funds -- and
21 there are certain timing conventions around the
22 purchase and sale of those instruments. Tri-party

1 repo currently unwinds at 3:30 in the afternoon.
2 So, if Kim has a margin call at 8:30 in the
3 morning eastern, there's no way the FCM can get
4 money out of that repo investment to fund her
5 prior to 3:30. It's just not possible.

6 Another example: The client had -- the
7 FCM had a repo investment and they want to change
8 that and invest in a U.S. government security.
9 The same-day purchase timing convention is too
10 early to use the proceeds of repo to meet that.

11 Another example is FCM simply wants to
12 make an initial investment in a Treasury security,
13 you know, if you use the artificial example where
14 the money's not sitting in the operating account
15 because it's still sitting in the repo investment
16 or sitting with Kim, you know, at the clearing
17 house, so they make the security purchase; the
18 custody account ends up with a long security
19 position, say \$10 million; the operating checking
20 account that's tied to it is 10 million overdrawn.
21 And I think the bank's position would be that if
22 the music were to stop right there, we'd like the

1 ability to unwind that transaction and sell the
2 security to fund the overdraft, because if we
3 can't do that, again, we're going to require
4 prefunding, and it may not exist. You suggested
5 relying on the firm's capital. In a lot of cases,
6 it's relatively small relative to the size of
7 these transactions.

8 MR. FERRIS: And I think, just to add
9 onto that, if banks -- if the clearing banks
10 followed that procedure and were then decaying
11 trades that were coming in where there were not
12 sufficient funds in the account, those decays come
13 back all of a sudden those are going to start
14 backing up at the end of the day into the Fed wire
15 against all the dealers, and then all of a sudden
16 you've got a settlement issue that's all getting
17 jammed into the end of the day where the FCM
18 community is trying to make investments but at the
19 time, you know, the banks are -- there's not money
20 there because the variation payment hasn't been
21 made or whatever the source of funds is, that now
22 you've created an issue on the securities wire as

1 well as, you know, other aspects. So, it has
2 ramifications from that respect.

3 MS. DIETZ: What -- let me just say that
4 when you talk about the investments of customer
5 funds, that's really for the benefit of the FCM.

6 MR. FERRIS: No. Well, benefit of the
7 customer.

8 MS. DIETZ: In what respect?

9 MR. FERRIS: So, the funds of the
10 customer are invested in interest-bearing
11 instruments, and the customers then receive that
12 interest income for the money that's left with
13 that FCM. So, it absolutely is for the benefit of
14 the customer.

15 MS. DIETZ: Well, we do permit FCMs to
16 retain any funds generated from investment of
17 customer funds, and they may pass along some to
18 the customers.

19 MR. FERRIS: Correct.

20 MS. DIETZ: But I think that in an
21 instance like that, it's not at the specific
22 instruction of the customer; it's something that

1 the FCM does on their own initiative. So, I just
2 -- again, going back to trying to make
3 distinctions or understand, it's a slippery slope
4 -- what's for the customer and what's for the FCM.

5 Bob, did you have a comment?

6 MR. WASSERMAN: Yeah, just -- I think
7 we're sort of foreshadowing an issue that we're
8 going to be covering in the next panel, but I just
9 want to identify it here, because it does seem
10 relevant. At bottom, there are only three sources
11 of capital that are involved here: There's a
12 particular customer who's trying to do something
13 who might prefund or might not; there's the FCM;
14 and there are the other customers. And so if
15 we're saying, well, gosh, the first customer can't
16 prefund, and the FCM, for whatever reason, doesn't
17 have enough capital to prefund, then what we're
18 doing is we're borrowing from the other customers.
19 And so I understand we need to make sure the
20 clearing house gets paid. We need to make sure
21 that the banks get paid. But the difficulty that
22 we're running into is we're doing it borrowing

1 from other customers, and that's somewhat
2 difficult.

3 MR. MURPHY: It actually flows both
4 ways. We talked a bit about the funds flowing to
5 the clearing house, but we'll see it on the other
6 direction as well. The FCM may have investments.
7 And clients with excess margin may ask for it
8 back. And, you know, today we might be inclined
9 to process one of those payments, creating an
10 intraday overdraft in anticipation of the
11 liquidation of an investment. And in this
12 example, we're not relying on someone else's
13 money, because that client has excess. But it's
14 tied up in one of those investments.

15 MR. WASSERMAN: But --

16 MR. MURPHY: And our -- you know, what
17 Scott and I would be forced to do is just throttle
18 that payment and not allow it to take place.

19 MR. WASSERMAN: But if I, as a customer,
20 have said, look, invest my money and convert my
21 cash into some securities, I might have to accept
22 the fact that, you know what, it might take me a

1 day to get that back, because if I want the cash
2 back it needs to be converted back out. If, on
3 the other hand, the FCM is, as is perfectly
4 legitimate, perfectly permitted, taking my cash,
5 investing it in securities, and now I'm asking for
6 my cash back and I didn't ask for it to be put
7 into securities, it seems to me then that telling
8 the FCM, look, you've got to make sure you have
9 enough capital so that you can give your clients
10 cash back without borrowing it from other clients
11 is not entirely unreasonable.

12 MR. FERRIS: You know, I --

13 MS. TAYLOR: They're not borrowing it
14 from other clients in the example that Kevin set
15 up.

16 MR. FERRIS: Yeah. They have -- their
17 client has excess.

18 MS. TAYLOR: That customer has money.
19 It's just in one state and he needs it in another
20 state.

21 MR. FERRIS: Yeah.

22 MR. MURPHY: So, what you're suggesting,

1 I guess, is that if the FCM -- and I don't mean to
2 put words in your mouth -- but if the FCM
3 anticipated those types of flows, they should
4 leave a long balance in their bank account in
5 anticipation of those flows.

6 MR. WASSERMAN: Again, the issue is --
7 and, you know, Kim, you make a good point that
8 while they might have it in the wrong form, the
9 issue is, though, we're putting -- to the extent
10 we're doing this, you know, there's efficiency
11 involved in not having to have the long balance,
12 to have the most invested at the highest rate.
13 There is some additional risk we're creating, and
14 as we've seen when things go wrong, those risks
15 can be realized and can cause the customers harm.
16 And so the issue that we need to balance here is
17 how can we achieve the things that we need to but
18 assign those costs to the folks who may be causing
19 them as opposed to the customer who's putting up
20 cash and saying why am I not getting my cash back?

21 MR. GREENBERGER: Yes, Phyllis, going
22 back to your point, I mean, I do -- the question

1 here is there's a shortfall and who's going to
2 make it whole in this temporary situation. And is
3 it the customer? Is it the FCM? I mean, I do
4 believe that the FCM -- this is -- the deposits
5 are for the benefit of the FCM, the FCM is putting
6 out who the depositories are. It's encouraging
7 the investor to do business through the FCM,
8 because the money will be well taken care of, and
9 I think -- I'm sort of inclined to agree with Bob
10 that the risk is very high, that the investor or
11 the other customers are going to pay the price for
12 the FCM's choice of dealing with that depository.
13 That's my view.

14 MR. FILLER: I sort of have to disagree
15 with Michael. First of all, you're proposing for
16 the first time that the FCM is now going to be
17 liable under 1.25 investments for any losses that
18 have occurred. Although, I believe the industry
19 has always believed that most FCMs have always
20 taken that view. So, you're basically codifying
21 industry practice or principles. But any
22 investments -- if a client gives me a hundred

1 thousand in cash and I'm an FCM and I invest that,
2 let's say, in a government security or money
3 market fund or whatever and that earns interest on
4 a daily basis, that interest is still deemed to be
5 customer property, because it's still sitting in
6 the 4D account. It's only when an FCM takes that
7 money out is it no longer deemed to be customer
8 property, and a lot of FCMs keep it in to make
9 sure they have greater excess funds. You have a
10 new rule, or it's -- you're codifying the NFA rule
11 of if you take out more than, what's it, 25
12 percent of your residual interest, you've got to
13 have CEO or the CFO or his or her designee notify
14 or approve that. I think the mechanics and
15 procedures that are being proposed here and that
16 the NFA has adopted recently are all going to
17 provide greater protection to the customers. But
18 as long as those properties or investments under
19 1.25 sit in a seg account as customer property,
20 have always been customer property, and the CFTC
21 has always taken the position that it's customer
22 property until the FCM withdraws, it's not

1 withdrawing customer assets, it's withdrawing its
2 excess funds out, which it has always been
3 permitted to do, provided of course that
4 withdrawal doesn't cause the account to become
5 under- segregated. So, I think you have the
6 protections in place, and I think the new
7 proposals are going to be good for the industry.

8 MR. BARNETT: Let me go -- I want to ask
9 a quick question. Go back to the overdraft
10 example rather than a 1.25 blowup or something
11 like that. So, the overdraft example -- I'm
12 assuming that the bank makes the overdraft
13 decision based on its analysis of the likelihood
14 of being repaid by the FCM and not by the
15 individual customer. It has no ability to look at
16 which customer is creating the overdraft, right?
17 So, on the other hand, are we aware of whether
18 there's -- and I don't know the answer or whether
19 somebody here knows -- whether there's any kind of
20 obligation in the customer account agreement for
21 the customer to reimburse advances made by the FCM
22 in respect of margin calls for instance and

1 whether that might be a legal basis for
2 reimbursement from the customer without reaching
3 into seg funds.

4 MR. FILLER: The customer agreement says
5 I, Client, agree to maintain proper margin at all
6 times. And if the client gives the FCM an asset
7 that is, you know a bad check or whatever, then
8 the client has not met their margin call, and
9 under most customer agreements have an Event of
10 Default clause provision, and if the client's
11 actions result in an event of default, the FCM can
12 then "liquidate" the open positions. If any
13 client still owes the FCM money after that
14 liquidation, then you have a breach of contract
15 litigation between the FCM and the customer. The
16 FCM, though, is still guaranteeing to the clearing
17 house any losses that that client may have had
18 from the trading of that account. We have a
19 zero-sum game. If that client lost money, some
20 client made money.

21 MR. BARNETT: So, if the FCM goes down
22 for something not caused by the default -- I mean,

1 just in the course of when it goes down -- there
2 are unmet margin calls just in the course of the
3 day or something like that, the obligation of the
4 customer to the FCM -- does the DCO have any
5 claim, or is there any -- I mean, the obligation
6 to make the margin call exists; there's a
7 receivable of a sort in the FCM's hands. Is there
8 --

9 MR. FILLER: If the FCM goes down during
10 the day, or the customer?

11 MR. BARNETT: Yeah.

12 MR. FILLER: Well, you have -- if it's
13 an obligation owed to the clearing house, then --

14 MR. BARNETT: The clearing house has an
15 obligation. There's a posting --

16 MR. FILLER: Right, but then you're
17 going to -- you know, anything else owed you have
18 the waterfall effect and other procedures already
19 in effect that have been instructed. The MF
20 Global and the Peregrine matters, though, didn't
21 deal with trading; they dealt with other issues
22 relating to the seg fund account, you know.

1 MR. MURPHY: Hey, Ron, maybe a different
2 way of thinking about this. When you -- and I'm a
3 little ignorant of this but when you were at
4 Lehman, would it have been the case if you had a
5 client that met their margin obligations with
6 Lehman by delivering in a security, like a
7 Treasury bill, to Lehman and then that client's
8 position generated a margin call with Kim and they
9 didn't deliver in cash to meet that call, you
10 would be able to liquidate the security, right?

11 MR. FILLER: We can liquidate their
12 security, and we can transfer their security to
13 the CME. So, we can do one or the other.

14 MR. MURPHY: And Kim, if you have an FCM
15 on your books that has securities pledges margin,
16 and they have a variation margin call and they
17 default, you can liquidate the collateral. The
18 banks want the same ability. So, if we have an
19 FCM with long customer securities in a custody
20 account, we have a shortfall in the cash account,
21 we'd like to have the same tools available to us.

22 MR. BARNETT: But a lien in the seg

1 funds is very different than having a direct --
2 what is it called, the self-enforcement -- I can't
3 remember. Under a UCC claim for instance, you
4 want some ability to draw the collateral over,
5 which is more of a UCC claim than you trying to
6 take a security interest in seg funds. And I
7 think that's troubling. So, I mean, if there are
8 issues there, we should put some --

9 MR. MURPHY: No, I understand it. It's
10 just that I know what we're struggling with, which
11 is that this is, you know, this is the way banks
12 have been --

13 MR. BARNETT: Self-help remedies is what
14 I was thinking of.

15 MR. MURPHY: Yeah.

16 MR. BARNETT: Sort of the creditor's
17 self-help remedy that's permitted under the UCC.
18 But if you don't have a security interest in those
19 rights then you can't draw it to yourself.

20 MS. TAYLOR: Can I take a try, though,
21 at what I think Kevin and Scott are trying to
22 explain? And tell me if I'm wrong. It sounds as

1 if the banks are not trying to say they don't want
2 to have the obligation to, as a relationship with
3 the FCM, all the seg accounts that they have to
4 make sure that they don't have a lien on -- that
5 they don't -- they're not trying to exercise a
6 lien on that as a whole; they're just trying to
7 have the flexibility to rely on money in one
8 account to fund transactions in the other account.
9 And it's a very blunt instrument to say that there
10 can be no overflow between those two accounts,
11 because you don't know, they don't know, I don't
12 know -- the only one who knows is the FCM --
13 whether the transaction that they're actually
14 trying to enact is all the money of the same
15 customer or is money that is actually excess funds
16 of the clearing member in their residual interest
17 in seg. So, I mean, that's kind of what you're
18 saying, right? You want to be able to rely on the
19 kind of overall seg relationship you have --

20 MR. BARNETT: That's an additional
21 piece.

22 MS. TAYLOR: -- and be able to keep that

1 whole as opposed to keeping every single account
2 whole.

3 MR. BARNETT: That's right.

4 MR. FERRIS: Right. But I think, to
5 Bob's point, I mean, there's -- and as you point,
6 it's a blunt instrument. We can't have -- we
7 don't have the transparent invisibility to ensure
8 that we aren't paying for one customer at the
9 expense of another. But short of that, which
10 really then drives to the outcome of -- you can't
11 allow -- a deficit in any seg account is -- there
12 are implications to that that I think the
13 Commission just needs to be aware of in the way
14 that FCMS will be able to function, the markets
15 will be able to function, and the customers of
16 those FCMS will be able to, you know, use these
17 markets. And so we can comply. It's very easy
18 for us to say no overdrafts. That makes our life
19 really easy, actually, but I think it makes the
20 industry's life very difficult.

21 MR. BARNETT: Well, I think the
22 overbroad -- I think there are some pieces that

1 may be able to be worked with, but -- Bob?

2 MR. WASSERMAN: So, to be clear, you
3 know, if the FCM takes the security out of seg,
4 gives you a security and essentially repos with
5 the bank, then the bank has its security; the FCM
6 has the cash that they need. It's the issue that
7 in order to have the lien, you need to have the
8 asset out of segregation and be clear what is
9 protected and what isn't protected. And part of
10 the problem with doing it otherwise is that we've
11 had, you know, an unfortunate incident in the
12 context of Lehman where there was some question,
13 shall we say, raised by a bank as to whether a seg
14 account was protected and whether money could
15 flow; and that kind of a misunderstanding at the
16 time of an insolvency is, itself, a problem that
17 would be very difficult to deal with, including,
18 you know, whether it's to go to the customers or
19 to go to the clearing house. And so the issue, I
20 think, is how can we make sure that it's very
21 clear this is in the bank, this is the bank's
22 collateral, they've got it, it's fine but it isn't

1 seg, and this is in seg and it's not the bank's
2 collateral so that you're moving. And it may
3 create a bit of an inefficiency in having to move
4 things from one account to another, but what it
5 does is -- maybe that's the way to make sure that
6 the bank has the collateral they appropriately
7 need, whereas the seg account is in fact kept
8 segregated and protected.

9 MR. GREENBERGER: I think Bob's analysis
10 is very helpful. It's clarified it for me what
11 the bank's problems are here, and I think for the
12 customer it just has to be clear. The customer
13 has to know -- if we're talking about the
14 customer, the customer's got to have his account
15 made whole -- that the customer understands he's
16 got one account that isn't segregated and can be
17 accessed by the bank to cover an overdraft and
18 that he has a specific account that is segregated
19 and can't be --

20 MR. ROE: I don't think that's
21 operationally possibly. I don't --

22 MR. WASSERMAN: Forgive me, what I'm

1 talking about is from the FCM's perspective, not
2 an individual customer.

3 MR. GREENBERGER: So, it would be the
4 FCM having the account that is accessible without
5 violating segregation, not the customer.

6 MR. WAASSERMAN: And it would not count
7 as seg. In other words, so long as you meet the
8 1.25 investment requirements, our requirements are
9 to amount not to form. And so, in other words,
10 you know, one customer gives you a million-dollar
11 Treasury, you're perfectly free to take that
12 Treasury and on a DVP basis have a million dollars
13 in cash. You could then take that million-dollar
14 Treasury, put it in a non-seg account, and allow
15 for that conversion, but, again, the FCM needs to
16 be able to fund that. But that's how you can
17 essentially reduce -- you know, be able to have
18 the liquidity but make clear that, okay, this
19 Treasury -- it's not because it's customer A's
20 Treasury, it's the FCM's seg account; therefore
21 the FCM has at all times the requisite amount in
22 seg. Yes, it may be that the -- you know,

1 obviously there's some expense from that and the
2 bank's presumably going to charge for that, and
3 the FCM is going to pay for that or some customers
4 may receive less return on their funds. But what
5 it does do is it is a means -- by keeping the
6 accounting straight and keeping what is in seg
7 "segged" and what is needed for liquidity out of
8 seg, it allows the bank to be protected and the
9 seg to be protected.

10 MR. MURPHY: Because if you --

11 MR. GREENBERGER: I stand corrected.

12 But I think the result is still the same, that
13 there is one account that affects segregation and
14 one account that doesn't, and it's the FCM's
15 account, not the customer's account, if I
16 understand that correctly, and that the account
17 that is not associated with segregated funds can
18 be used by the bank to make up overdrafts in the
19 segregated account. That seems to be perfectly
20 fine. And, by the way, let me say this is a very
21 constructive discussion, because this stuff was
22 all - pre- this proposed rule -- I think a mystery

1 to a lot of people, and I think we're clarifying
2 issues here that are very, very constructive. But
3 I think that there has to be a clear separation of
4 the accounts that can be dipped into to deal with
5 overdrafts and that those accounts not in any way
6 need to be taking out segregated funds, if I
7 understand that correctly.

8 MR. FERRIS: Well, I think said another
9 way, it's really going to get to what your next
10 panel's about, which is residual interest, because
11 as soon as you take it out of seg, it's a residual
12 interest. So, they're going to have -- the FCM's
13 going to have to maintain a sufficient amount of
14 liquidity in the customer seg account. That's
15 their residual interest to manage the daily flows.
16 I think that's ultimately the bottom line.

17 MS. TAYLOR: Including to keep enough
18 cash so that they don't need any cash from
19 investments they might make until 3:30 in the
20 afternoon. I mean, I think we've just ratcheted
21 up the impact of that viewpoint another time.

22 The example that I'd like to put out on

1 the table just so that everybody's thinking about
2 it is this. An FCM is perfectly free to accept
3 from its client a Treasury security and
4 satisfaction of all requirements that the FCM has
5 from the client. But the FCM owes the clearing
6 house cash for the mark-to-market. And so in
7 order to pay the cash for the mark-to-market, the
8 FCM needs to be able to rely on the value of that
9 security that they might have to sell or repo out
10 to get the cash, and the timing of that is such
11 that it can't be done in line with the times at
12 which the clearing member needs the cash.

13 MS. DIETZ: Yeah, it's --

14 MS. TAYLOR: But it's the same
15 customer's money.

16 MS. DIETZ: Right.

17 MS. TAYLOR: So, it's the same
18 customer's money. The customer is not
19 disadvantaged if you're allowed to rely on the
20 forthcoming proceeds of selling the security in
21 order to meet the cash obligation. The customer's
22 actually advantaged by being able to, for the most

1 part, have a Treasury security up with the
2 clearing member instead of cash, where they might
3 not earn a return. I mean, this all matters more
4 when there's actually a return to be earned.

5 (Laughter) But, let's pretend that
6 there will be someday. But that's
7 -- I guess I can just come back to
8 the fact that it's a very, very
9 blunt instrument that we're
10 applying here, because the bank has
11 no way of knowing that it is the
12 same customer's money or it's not
13 the same customer's money or it's
14 from residual interest or what the
15 money is due from.

16 MR. ROE: And it's impossible to
17 identify that in enough time to make it
18 significant for the FCM. So, I think you have to
19 do another run at this instead of looking at it
20 from that perspective, because there's no system
21 you can enact where you're going to be able to
22 identify -- in the middle of all these

1 transactions, we're not talking about one customer
2 with Treasury, we're talking about thousands of
3 customers. And as the example that was just
4 discussed with J.P. Morgan and Lehman, I think it
5 sort of alludes to what can happen and how that
6 can create serious liquidity problems if you try
7 to do something like that.

8 MS. DIETZ: Let me just ask. There is
9 in the form acknowledgment letter in the paragraph
10 that prohibits taking liens on customer property
11 to secure credit, but it says, "This prohibition
12 does not affect your right to recover funds
13 advanced in the form of cash transfers you make in
14 lieu of liquidating non-cash assets held in the
15 accounts for purposes of variation settlement or
16 posting initial original margin." Does that help
17 at all? Is that --

18 MR. MURPHY: That helps tremendously.

19 MS. DIETZ: Yes, okay.

20 MR. MURPHY: And what we'd like, though,
21 is to see that go one step further. And, see,
22 that language was a great addition. It reflects

1 the operating reality of how these flows work.
2 We'd just like to see it go one step further and
3 address these other timing issues related to
4 liquidating Treasuries, liquidating repo,
5 supporting DDPR repeat transactions -- because
6 these are all -- this is real. This is how these
7 flows function today and have for a very long
8 time. And, you know, as Scott underlined, you
9 know, we can stop this. We can require prefunding
10 on everything. But I don't know if the system can
11 really work that way.

12 MR. FERRIS: But the one pitfall this
13 raises, though, is it is virtually impossible on a
14 minute-to-minute or second-to-second basis for the
15 bank to know the exact sources of funds for every
16 outgoing payment. And so while we could say okay,
17 we're going to make a variation settlement and
18 there's an asset that's going to be liquidated to
19 deal with that variation settlement, we don't have
20 the capability to look at that transaction in
21 isolation at the same time thousands and thousands
22 of transactions are flowing through the

1 institution on a daily basis for, you know, tens
2 if not hundreds of FCMs and customer accounts.
3 So, it gets us, I guess, a little bit of air
4 cover, you know, if we were able to isolate that,
5 but we're really sort of flying blind on that.

6 And I think the other aspect of this is
7 while this talks about a non-cash asset, we have
8 clients -- a typical client with us would have
9 U.S. dollar seg accounts, and they may have up to
10 as many as 12 foreign currency seg accounts with
11 us, which we -- you know, we typically -- we
12 historically have viewed cash as fungible
13 irrespective of the currency. So, looking at the
14 way that the letter is written, we would not be
15 able to look at a U.S. dollar asset to cover a
16 euro deficit or a Japanese yen deficit when, in
17 fact, what will happen is our client will come to
18 us and say can we do an FX trade, which
19 effectively will cover that, but you're not
20 allowing the bank to effectively protect itself
21 while the client is in the midst of effecting
22 those transactions. So, it goes beyond just

1 non-cash assets, and I think it also becomes very
2 difficult to isolate.

3 MR. FILLER: May I raise a different
4 issue -- and I know we don't have much time left,
5 so I just want to throw it out, and it's something
6 that is personally important to me. And despite
7 what others might think, I was not around in 1937
8 (laughter) when the Commodity Exchange Authority
9 issued their administrative letter regarding that
10 an FCM, as long as it uses reasonable due care in
11 selecting a custodial bank, is not liable for the
12 act. I know staff has at different meetings
13 thought that an FCM is liable for losses that a
14 custodial or depository might deal with seg funds.
15 And you're now proposing that as a question of
16 whether or not FCMs are liable for losses incurred
17 by a bank, you know; and just as in the
18 acknowledgment letter, you're dealing with a
19 standard of liability for the banks. I think the
20 proposed language is "has reasonable knowledge of"
21 some kind of -- "the banks have reasonable
22 knowledge," and if I'm the banks, I'm going to be

1 asking for my comment letter's actual knowledge
2 versus a reasonable standard. But the FCMS don't
3 have any knowledge of what the banks are doing,
4 and I don't just -- I'm a big believer that FCMS
5 should be liable for losses incurring with
6 investments under 1.25. They have direct
7 knowledge of what they're doing. FCMS should not
8 be liable for any losses that might be incurred by
9 a custodial bank or other depository, because it's
10 beyond any of their controls whatsoever. So, it's
11 just something personal on my part that I want to
12 get out.

13 MR. GREENBERGER: Yeah, I just want to
14 go back to fundamentals, again dealing with
15 non-sophisticated hedging customers. A lot of
16 them -- pre-MF Global, what have you - think like
17 many people who go into a bank and put their money
18 in a savings account, think the money goes down to
19 a basement and the bank keeps it all there. There
20 is a lack of understanding about depositories and
21 that the bank actually sends it to depositories.

22 I am comforted by Tom's point that,

1 well, you're not going to give me an
2 acknowledgment letter, but if the acknowledgment
3 letter is standardized and the customer knows who
4 the bank is using as depositories, they get that
5 information I would like them to get. But I still
6 think somehow the customer -- not talking about
7 the sophisticated ones but the run-of-the-mill
8 retail customer -- needs to comprehend where all
9 this money is going and what sureties he's
10 getting, she's getting, or the FCM is getting.

11 The final thing I wanted to say is, as I
12 said earlier, I've had a lot of discussions with
13 people outside of the Refco context about money
14 being moved for not 1.25 purposes but the
15 customer's purposes, and there's a lot of
16 confusion out of that. I do feel obliged to say
17 -- Ron brought up Refco -- there is a case in the
18 southern district of New York about that
19 particular thing. I am an expert witness in that
20 case. I am serving in a professional capacity.
21 That's in dispute. I'm not worried about it. I'm
22 looking forward to trying to clarify for customers

1 what is needed to make it clear that you want to
2 move money out of segregation and into another
3 account.

4 MR. BARNETT: Okay, last thoughts?
5 Todd.

6 MR. KEMP: Yeah, just generally, you
7 know, we are all about customer protections. We
8 had a lot of members caught up in MF Global.
9 We've made a number of recommendations to the
10 Commission for enhancements. We've done so very
11 deliberately, though, with the knowledge that for
12 every customer protection enhancement there's
13 probably a cost created. And our view is that
14 eventually those costs are going to be driven
15 through the system back to customers. We know the
16 clearing house is going to get paid; the banks are
17 going to get paid; the FCM is going to be held to
18 the letter of whatever you guys decide. We fear
19 that some of those costs are going to be driven
20 down to the customer, possibly in forms of
21 pre-margining, intraday margining.

22 Bob was right. This kind of presages

1 the next panel's discussion, but that is going to
2 run completely counter to every instinct that our
3 industry has right now. Do we want to send more
4 money to the FCMS? What happens in the event of
5 the next insolvency? You have more funds at risk,
6 more customers at risk. That's going to be our
7 mantra, if you will: Think back to the customers;
8 think back to the impacts on green companies, on
9 pork producers and other farmers. It's a big
10 issue, and it's real money to these folks.

11 I understand that the FIA may be doing
12 some work on potentially the volume of additional
13 margin funding that could be needed for some of
14 these proposals, and I'm looking forward a little
15 bit more about that on the next panel.

16 MR. BARNETT: Great, okay, thank you.

17 MR. ROE: Just to piggyback on that,
18 you're looking in the right direction in a lot of
19 respects. I mean, if we look at -- if we could
20 call what "it" was that hit the fan at MF Global,
21 it really sort of ended with a transaction trying
22 to cure an overdrawn account in a foreign

1 affiliate. So, you guys are looking in the right
2 space. But we have to be very, very conscious of
3 what Todd was referring to in terms of costs, and
4 are we putting undue operational complexity on top
5 of a system and actually making that system more
6 costly to customers and perhaps creating more
7 insolvencies in terms of FCMs. And maybe there
8 are other ways to look at it, like perhaps looking
9 at going into the bank, which I know is outside
10 the purview of the Commission, and subordinating
11 the claims of affiliates over customer property.
12 We have to look at how the property really works,
13 not only as it's transferred around all of these
14 different depositories and all these institutions
15 that touch it, but what happens when "it" hits the
16 fan and someone covers an account in a foreign
17 affiliate.

18 MR. BARNETT: Okay, thank you. Others?

19 MR. WASSERMAN: One request. You know,
20 hopefully you folks are all going to be commenting
21 on this rulemaking. As you know, the deadline is
22 the 15th. It would be helpful if you identify --

1 if there's something we can do better, explain
2 how; if there's something different you want us to
3 do, be maximally specific. Ideally, if you can
4 tell us, gosh, we think you ought to use these
5 words, because telling us, well, do better is --
6 yes, I mean, we try.

7 MR. ROE: Not specific enough.

8 MR. WASSERMAN: But the more specific
9 you are, the more helpful it is and the more
10 productive it is for the process.

11 MR. BARNETT: Kim gets the last word.
12 You've got your mic opened up.

13 MS. TAYLOR: I just wanted to basically
14 echo the comments that some of the customers made
15 that ultimately I think the whole industry is very
16 focused on customer protection, but there are many
17 ways in which customers are protected, and some of
18 those include having access to being able to use
19 the markets in a cost-effective way, and some of
20 what is being discussed here I think will make
21 that more difficult perhaps than it has been in
22 the past.

1 And then the other item that we didn't
2 ever mention here that I just wanted to talk about
3 with respect to this particular seg letter is that
4 I think I would be interested in having there be
5 some conditions around the situations under which
6 the CFTC would order funds transferred out of
7 segregated accounts. And I think I'm on board
8 with where you're coming from. I think that it
9 probably stems from situations like Sentinel or
10 situations like Lehman where the CFTC took some
11 action to try to get funds moving. And so
12 conceptually I think that is -- I'm on board with
13 that. But there is also a reliance by the FCM or
14 perhaps by the bank and certainly by the DCO on
15 the monies that are known to be in those accounts,
16 and if they are seized without -- I don't know the
17 proper conditions around that -- that could be
18 problematic.

19 MR. BARNETT: Thank you all very much.
20 Really appreciate your help.

21 Fourth Session - Residual Interest Requirements

22 MR. WASSERMAN: Can we get everyone to

1 sit down in about a minute? I definitely don't to
2 delay, folks' flights and trains home, so perhaps
3 we can get started.

4 My name is Bob Wasserman. I'm with the
5 Division of Clearing and Risk, and I should
6 probably start with the normal disclaimer, which
7 is that the views expressed by the staff are the
8 views only of those staff and do not necessarily
9 represent those of the Division or the Commission
10 and indeed if we're told to by competent authority
11 may not even represent the views on the opinions
12 of the folks who once uttered them. (Laughter)

13 And so the focus here, as already
14 foreshadowed by the last panel is to address the
15 residual interest issue and, in particular, an
16 issue that has been sort of hiding in the rules I
17 think in some ways since the 1930s but has, as
18 we've gotten more focused on customer funds
19 protection, become much more important, which is
20 the prohibition against using the collateral of
21 one customer to margin, guarantee or secure the
22 positions of another. And so we have a proposal

1 in this regard that would require FCMS to
2 basically fund themselves the margin deficits of
3 their customers, and we want to address the issues
4 that are involved here.

5 A very significant one that I definitely
6 want to cover here is the timing issue, because I
7 know that may well contribute to how difficult
8 this is to achieve, but there are a lot of other
9 costs and practicality issues and I think we
10 should discuss them. And so I will open the
11 floor.

12 MR. THUM: Well, I could start, and I'll
13 just repeat what I said earlier today. I'm Bill
14 Thum from Vanguard, and Vanguard represents the
15 buy-side real money manager, 2 trillion under
16 management, 9 million shareholders. We use swaps,
17 futures, and FX to carefully hedge portfolio risk
18 and lower transaction costs and achieve more
19 favorable execution. We've been very supportive
20 of the CFTC's moves to increase regulator
21 transparency and set appropriate margining levels
22 for trades and the clearing of standardized

1 trades.

2 Keeping in mind that at present our
3 swaps are done over the counter. They're not
4 cleared. They're fully collateralized on a
5 bilateral basis. Collateral is held by tri-party
6 custodians, and there is either no or very limited
7 fellow customer risk, fraud, or malfeasance risk,
8 investment risk, or operational risk presented.

9 Vanguard strongly supports the CFTC's
10 proposals in this proposed rule to amend Parts
11 1.22 and 30 to provide greater certainty that
12 customer funds will be protected; require FCMs to
13 establish robust risk management programs; provide
14 CFTC and SROs transparency into accounts holding
15 customer funds trust but verify; ensure FCM
16 capital and liquidity are sufficient to safeguard
17 operations; provide enhanced auditing of FCM
18 compliance and enhanced disclosures provided to
19 customers. We feel that these will significantly
20 mitigate risk and provide clients with information
21 to allow them to assess the viability of their FCM
22 to have the ultimate backstop protection, which is

1 the ability to port their trade in a knowledged
2 way.

3 Now, Vanguard also appreciates the
4 CFTC's proposals to further tighten protections of
5 customer funds, including prohibiting an FCM from
6 co-mingling futures customer funds from FCM
7 proprietary funds or futures funds from cleared
8 swaps customers and prohibiting the FCM from using
9 one customer's funds to secure another customer's
10 positions or using one customer's funds to extend
11 credit to any other person. However, key to these
12 protections is the discipline provided by the need
13 to maintain intraday segregation and pose capital
14 charges related to undermargin customers and
15 require residual interest to be maintained.

16 With respect to the capital charge, CFTC
17 has proposed an accelerated time table for
18 assessing a capital charge if an FCM has an
19 undermargined account. Whereas previously a call
20 on a Tuesday based on Monday's close raised a
21 capital charge on Friday if a customer failed to
22 transfer funds, under the proposed rule the

1 capital charge will apply Wednesday. We think the
2 accelerated timetable makes sense, given modern
3 trade and asset transfer timing, and it will serve
4 to make it more transparent when an FCM is
5 extending credit to a customer for an extended
6 period. We strongly feel each customer must stand
7 up for their own trades. If they can't put the
8 margin up, they shouldn't trade.

9 Vanguard is especially pleased to see
10 Section 1.20(a), which confirms that an FCM must
11 maintain segregation at all times and not merely
12 at the end of the day. New Section 1.20(i)
13 effectively changes the practice. Whereas
14 previously an FCM was required to hold sufficient
15 funds in segregated futures customer accounts to
16 ensure those accounts don't become
17 under-segregated, the proposed rule requires FCMs
18 to maintain sufficient funds in futures customer
19 accounts to cover all margin deficits and to
20 ensure the accounts aren't under-segregated. This
21 ensures there is both adequate margin and full
22 segregation. The FCM can no longer look to one

1 customer's excess to cover another customer's
2 shortfall.

3 Going forward, the FCM must either lend
4 customers margin to cover the deficit, a residual
5 interest, or ask each customer to prefund to cover
6 new trades. The new proposal effectively shifts
7 risk from the customers with excess to customers
8 with deficits. And we agree with the shift, as we
9 don't want our margin excess used to support other
10 customers in any way. The cost will be
11 appropriately increased, as customers will have to
12 pay their own freight as they enter new trades.

13 MR. COHN: Thanks, Bob. And I'm Josh
14 Cohn with Mayor Brown. I'm here speaking for the
15 International Swaps and Derivatives Association --
16 ISDA -- and ISDA is grateful to the Commission for
17 the invitation to be at this roundtable, and we're
18 speaking today with respect to cleared swaps and
19 the residual interest question.

20 ISDA is an advocate, of course, for safe
21 and efficient markets and has been a long-time
22 supporter of LSOC. We're concerned, however, as

1 the market understanding of LSOC deepens and as
2 LSOC for swaps is elaborated by the present
3 residual interest proposal that the costs of LSOC
4 are poorly understood. We urge the CFTC to
5 collect and consider cost data before finalizing
6 the residual interest proposal or taking any other
7 steps, and I speak with particular reference to
8 page 67916 of the November Federal Register
9 release in which the CFTC said, "Therefore the
10 Commission does not have adequate information to
11 determine whether FCMs typically hold residual
12 interest that is greater than the sum of their
13 customers' margin deficit and cannot estimate the
14 cost of the proposed rule."

15 ISDA preliminarily estimates the
16 additional funds required across swaps -- and I'll
17 poach a little on others' territory -- futures --
18 to support the residual interest proposal to be in
19 the \$200-250 billion range with an annual cost of
20 funding of \$2-2.5 billion. It's unclear where
21 these funds would come from, and many have been
22 addressing that question. Customers, of course,

1 could be asked to pony up an additional 60-75
2 percent of their present collateral requirements,
3 but will customers regard that as worthwhile or
4 appropriate? It's vital to consider real costs
5 and ultimately real benefits for those costs. If
6 there are real benefits and if the costs are well
7 understood, the market will be able to allocate
8 those costs.

9 Thanks.

10 MR. WASSERMAN: So, before we go on --
11 as I mentioned last panel, best as I can
12 understand there are only three sources of funds
13 here. There's the margin coming from the customer
14 who's taken the particular positions; there's
15 collateral that is posted from the FCM out of its
16 own funds; and then of course there's excess
17 collateral posted by other customers.

18 So, is what you're saying, Josh, that at
19 this point some -- you know, as we sit here today,
20 some \$200 billion of funds from customers with
21 excess is being used to margin positions of
22 customers who have not yet funded their positions?

1 MR. COHN: I don't know if I can make
2 that direct connection.

3 MR. NUNERY: May I also ask, you've
4 indicated some cost estimates there. Is this to
5 be able to provide calculations associated with
6 those costs in the comment letter?

7 MR. COHN: They are preliminary. We are
8 planning to do a comment letter. Whether we're
9 able to get our arms around these figures
10 sufficiently to do more than we have today we'll
11 have to see. I hope so.

12 MR. WASSERMAN: To be very clear, we
13 really would appreciate that kind of detail in a
14 comment letter, so, I mean, again, we have very
15 specifically asked for cost information, and we
16 really do want to get it.

17 Ron.

18 MR. FILLER: Sure, thank you, Bob, and
19 thank you for inviting me today.

20 I'm going to talk mainly about the
21 residual interest proposals. In some respect, the
22 proposals have conflicting language in some parts

1 of it. Each FCM under the risk management
2 procedures should independently determine how much
3 should be in the residual interest or excess
4 funds.

5 And then you also proposed that if
6 there's ever a margin call the residual interest
7 should equal or exceed the margin calls that might
8 be owed by the clients for that day. I really
9 believe the risk management procedures is the
10 preferred the approach. Let each individual FCM
11 determine to what extent and what amount of
12 residual interest they should have in each of the
13 three buckets. Those amounts are now being
14 disclosed on your website under the FCM data under
15 the Excess Fund column, so the public knows. And
16 based on some of the discussions we had earlier,
17 there may be even additional reporting of those
18 numbers to the NFA website or the FCM website,
19 depending on the location.

20 I think if you look at the margin call
21 approach that you have proposed, if I were back in
22 the FCMs I'm going to require my customers to not

1 only have additional margin put up, maybe two
2 times, so you never have a margin call. I'm going
3 to prefund a lot of that. And the other part of
4 it is a lot of the funding on this T+1 basis --
5 when I was at Lehman we had as many of the large
6 asset managers as clients, you know, hedging the
7 futures an area, and some of the asset managers
8 had several hundred -- and one even had over a
9 thousand -- accounts with us, all hedging
10 primarily the fixed income rates with their
11 accounts. And when you're managing that type of
12 large number of accounts -- and I looked at those
13 accounts as zero risk to the firm. They were all
14 large in ERISA plans, mutual funds that have
15 allocated a certain portion of their assets to an
16 individual money manager. I looked at them as
17 zero risk to the firm.

18 But we had times where, for pure
19 administrative reasons only, the money managers
20 instruct the custodial banks or the trustees to
21 then transfer the money over to the FCM to meet
22 their respective margin calls, and there would be

1 times it would take more than one day to do so.
2 So, this one-day margin call approach that you're
3 also considering for a capital charge -- I think
4 you need to revisit it at least with respect to
5 hedge margins, because I think a lot of these
6 hedge margins are made, and to me they're less
7 risk. But I don't think the one-day margin call
8 is the appropriate standard whether you want to go
9 from three to two, but I don't think going from
10 three to one day.

11 The other part of that analysis, as
12 again I'll speak when I was Lehman, we had clients
13 trading all over the world. You cannot move money
14 from Asia to the U.S. within a 24-hour period.
15 Sometimes it takes 48 hours or more to get that
16 money, and yet we would have a capital charge
17 because it wasn't met on the T+1 basis as you
18 propose. So, I really believe that you've really
19 got to go back and -- Josh mentioned it -- do
20 further studies on this, because I don't think
21 there is sufficient data to do it.

22 I've heard, not the numbers that Josh

1 threw out, but I heard that the cost to comply
2 with your residual interest margin call will be in
3 the billions. And this is just -- I read some
4 other information. I don't have any data to
5 support that. But that was only for futures. And
6 when you add the swaps to the world, I can see
7 Josh's number of \$175 billion type of a cause.

8 So, I really think this really requires
9 some further study, and all of these proposals on
10 residual interest and the one-day margin call
11 would not have prevented MF Global and would not
12 have prevented Peregrine. So, I think before we
13 rush into it -- and there is a need to protect the
14 customers. I'm probably the biggest, strongest
15 believer in protecting customers, but I think we
16 need a rational approach before we just start
17 adding all these other changes, because I don't
18 think the FCMs have enough capital to play the
19 game with your 8 percent capital requirements for
20 a margin. And now if you adopt this rule on the
21 residual interest -- if you have a margin call,
22 you've got to have residual, which is more capital

1 -- I am quite concerned that the FCMs are going to
2 shrink in size to where there will only be a few
3 number of FCMs playing the game, and I don't think
4 that's a healthy part of the industry.

5 So, I really believe further study needs
6 to be done. I am not a supporter of the residual
7 interest on the margin call. I believe each FCM
8 should make its own decision of what the proper
9 amount of residual interest should be. They will
10 disclose that, as we were talking about earlier,
11 and the whole world will know whether or not that
12 residual interest is a proper amount to do
13 business with, with that FCM.

14 MR. WASSERMAN: Jim?

15 MR. KOUTOULAS: I agree with -- it's
16 Ron? -- I can't quite see your -- Ron's comments
17 here. I think that the proposed regs are, at the
18 spirits, excellent. But the implementation is
19 going to be full of unintended consequences, and
20 it's going to cause a lot of prefunding by
21 customers, which is going to be a de facto hike in
22 margin requirements, except these increased -- you

1 know, effective margin requirements aren't going
2 to be held at the exchange; they're going to be
3 held at the FCM. And post-MF Global and PFG, I
4 think the last thing customers want to do is
5 prefund and have more cash on deposit with FCMs.
6 And I think that perhaps something that might be a
7 little bit more effective to explore is to talk to
8 Todd over there about national grain and feeds,
9 tri-party or quad-party segregation models, which
10 you could achieve a similar result and make sure
11 you've got enough cash on hand to fund these kinds
12 of things. But the money could be held at a
13 third-party custodian, like a bank, and tab for
14 margin rather than having it be prefunded at the
15 FCM.

16 MR. WASSERMAN: So, again, here's the
17 difficulty that I still can't get my arms around.
18 The money is coming from one of three places. If
19 we're saying we're not going to have the customers
20 prefund and we're saying the FCMs don't have the
21 money, somebody has some excess out there, because
22 Kim's not waiting for it. She wants it today.

1 So, where is that money coming from? And I'm
2 thinking it's coming from Bill, who might have
3 some extra up there, or maybe he won't after
4 today. But in order for this to work, somebody
5 has some extra margin. Somebody has some extra
6 collateral up there.

7 MR. THUM: If I could just add a
8 question to that as well. So, in the
9 over-the-counter market now, under our ISDA master
10 agreements and credit support annexes, certainly
11 when the '94 credit support annexes published, the
12 timing for margin transfer was make a demand by a
13 certain point in the day and the margin has to be
14 transferred by the end of the second business day.
15 Now, of course, I would be surprised if any dealer
16 would accept a two-day margin transfer for an
17 over-the-counter swap. Most make a demand by 10
18 a.m. for margin transfer by end of day.

19 I also certainly know, because I worked
20 at a dealer for a very long time, that for certain
21 hedge fund clients, the possibility for intraday
22 calls are often used. So, I do know that for the

1 swaps trading now, margin is transferred same day.
2 So, I'm trying to figure out, you know, why -- I
3 know this represents a significant change for the
4 futures market. But in terms of the cleared swaps
5 market, it does not represent an accelerated
6 timeframe, given my experience dealing with ISDA
7 documentation and margin transfers.

8 MS. TAYLOR: If I could add something to
9 the point that Bill was making about the
10 distinctions maybe between the swaps market and
11 the futures market.

12 The CME is very much a strong proponent
13 of strong customer protections, and I think that
14 the industry has done a lot in the time of
15 implementing the OTC clearing to enhance customer
16 protections and also in the wake of MF Global and
17 Peregrine Financial. But one of the things that
18 is kind of paramount to the protection of
19 customers in general is that there be a strong
20 system for them to operate under. If you think
21 about the goals of the G-20 and Dodd- Frank,
22 really the goals were kind of two things: More

1 transparency in the markets and better resiliency
2 in the markets.

3 And Bill talked actually this morning on
4 the earlier panel about one of the strongest
5 protections for a customer being the portability
6 of his positions and his collateral in a time of
7 trouble. And one of the things that I believe Ron
8 was pointing out is that changing the dynamics of
9 this industry so potentially dramatically for
10 certain types of customers that are served by a
11 small selection of firms that will potentially be
12 reduced. And I'm talking primarily about
13 agricultural hedgers, other small commercial
14 hedgers, and potentially some of the contributors
15 to the speculative activity that helps with the
16 risk transfer.

17 So, if we're raising the cost and
18 reducing the availability of the agricultural
19 hedgers to do business because they'll either need
20 to advance pay or double margins effectively. And
21 the way that they finance their hedging requires
22 that basically they show proof of losses or proof

1 of a margin call in order to advance the -- get
2 the financing advance. There's a timing element
3 there.

4 They are also serviced by a relatively
5 small set of firms already, and if the costs of
6 doing business for that set of firms increase
7 significantly, there a good chance that there will
8 be a reduction in the number of firms that service
9 that particular clientele. There's actually a
10 reasonable chance that even the large, very well-
11 capitalized, broad-based institutions that are not
12 relying on futures as their main revenue stream
13 but have a kind of balanced financial relationship
14 with their clients will make a different decision
15 about how they service the futures business, which
16 could affect the financial hedgers who are hedging
17 things like mortgage rate risk. So, if we don't
18 have an environment where there are services
19 provided and there is choice and there's a place
20 to be portable to if there is a problem, that is
21 actually I think one of the risks that we're
22 under-weighting in the way that this has been

1 viewed to date.

2 MR. DAWLEY: A couple of things, Bob.

3 Look, I think it's important to note -- first of
4 all, I don't think there should be any shock as to
5 how some of these calls are funded. The futures
6 business in industry has grown and evolved and has
7 created an ecosystem with technology and workflows
8 that involve the gross omnibus model. It's been
9 in existence for years. And that allows FCMS to
10 fund these timing gaps with customer funds. And
11 what we're hearing here today, from you via the
12 LSOC discussions we had early on and you repeated
13 constantly -- and I'm not disagreeing with it.
14 And what Bill has said today, too, is that nobody
15 wants to allow one customer's funds to be used to
16 support another's deficit. So, if that's what
17 we're saying and we feel that that's the path that
18 we have to go down, then we have to realize what
19 that means. That means changing an ecosystem
20 that's been in existence for decades, and we can't
21 underestimate and underappreciate how big of a
22 deal that is.

1 Whether you call it prefunding or you
2 call it not allowing this use of one customer's
3 funds to fund another or you call it what's in the
4 rule, the requirement to have a residual interest
5 that's at least as great as your margin deficits,
6 it's all the same thing. It's changing the
7 futures model. And if we have to go down that
8 path, I would encourage the Commission to spend a
9 lot more time focusing on what the unintended
10 consequences are. It may be the right decision
11 long term, but don't underestimate how big of a
12 deal it is.

13 You know, I'll just also share with you
14 -- a couple folks asked about what FIA is doing.
15 We're doing a lot in this area. Ever since this
16 rule set came out, we've gotten a very large team
17 of people analyzing the rules trying to determine
18 the effects it will have on the industry. We've
19 hired Deloitte & Touche to anonymously gather some
20 data and analyze how it may affect FCMS. But it's
21 not just about the FCMS, because this is
22 ultimately going to hit the customers and end

1 users. There was some question as to whether that
2 might happen or not. Trust me, it will happen,
3 and it's going to be a pretty big number.

4 A couple of other things that we've kind
5 of recognized, and you know, these are early days.
6 We've just started to scratch the surface of how a
7 change like this might affect the industry. But
8 it's clear that a lot of FCMS will not be able to
9 survive once this change is made. So, there needs
10 to be time for FCMS to determine whether or not
11 they can in fact operate in the new world. A lot
12 of FCMS aren't even truly aware of what effect
13 this might have on their firms. So, they really
14 need some time, and we need to make an all-out
15 effort to educate firms as to what this means so
16 they can calculate their costs and figure out how
17 they're going to operate their businesses. Then
18 there's a whole effort needed to educate the end
19 users and explain to them what's changing, why
20 these additional costs are being put upon them.
21 And, you know, they're going to have to make some
22 decisions themselves. I think we have to take a

1 look at liquidity. Could liquidity be affected if
2 a lot of market participants are forced out of
3 this business?

4 But I do think it's important to note
5 that this isn't a surprise, right? This is how
6 we've operated for 50- plus years in this
7 business. And it's not -- it shouldn't be a shock
8 for anybody. If we want to change that model, so
9 be it. But let's not underestimate the effects it
10 might have.

11 MR. WASSERMAN: Just a couple of points.
12 I mean, I've been through a couple of FCM
13 bankruptcies, and it's amazing how surprised
14 people are at what those of us who are insiders,
15 you know, take as a given. Among those folks who
16 tend to be very, very surprised at what we're
17 letting people get away with are folks on Capitol
18 Hill who are very, very surprised that we let
19 this, that, and the other thing happen.

20 The other thing I just should note --
21 you know, as Todd mentioned at the end of the last
22 panel, as you just mentioned -- and, believe me, I

1 am very, very well aware of -- to the extent there
2 are costs, those costs flow. Again, what we're
3 dealing with here is a number of cases where --
4 now, there's a bit of a zero-sum aspect here. On
5 the one hand, the capital has to come from
6 someone; on the other hand, the costs are going to
7 be incurred by someone, and most often those end
8 up flowing down to the ultimate customer, and to
9 come back to the issue because the flip side of
10 what you're saying is: Look, before you do this,
11 make sure you realize what the cost is. And
12 that's a fair point, and that's something we're
13 obligated to do. On the other hand, we also need
14 to be aware of what is the cost of not doing it,
15 and essentially if we're saying well, it's too
16 expensive to essentially have customers prefund or
17 have FCMS fund, what we're saying is it is
18 therefore necessary to use the funds provided by
19 those customers who do provide excess. Again,
20 zero sum. That excess is coming from somewhere.
21 So, there are customers out there who are
22 providing excess, and what we're doing is putting

1 that at greater risk, and something tells me that
2 it's going to be very difficult to build an
3 adequate disclosure scheme that basically says,
4 hey, if you post excess, it's being used for
5 others.

6 MR. DAWLEY: I don't disagree, Bob, and
7 I would just add to that I think you also have to
8 take into account the technological and
9 operational changes that are going to be needed,
10 because the entire system -- and it's a global
11 system -- has been built for this legacy model.
12 And if we're going to change it, there needs to be
13 a thorough analysis about what it's going to take
14 to get everybody in a position where they can be
15 compliant. You know, once again the initial scrub
16 of what the operational challenges are is quite an
17 eye-opener. It's amazing what 50 years-plus can
18 create. And to unwind it with one sentence in
19 this rule is a pretty big deal.

20 MS. TAYLOR: And, Bob, if I could just
21 add on to what Mike is saying with a specific
22 example.

1 If you look at the practice of
2 collecting intraday pays and collects at the
3 clearing house level, that is a practice that
4 we've had at CME since 1988. And we operate that
5 practice with the clearing members in a way that
6 gives them very little time to fund. They're
7 asked to fund their requirements within a half
8 hour, an hour at the most of the time that we
9 notify them. We do a lot of things to help them
10 prepare for that during the day. But if they were
11 going to comply with the strict constructionist
12 aspects of this new regulation, it would be almost
13 physically impossible for them to do it with the
14 way that their business operates now, because we,
15 by definition, perform this intraday at a time
16 that is unspecified. It's within a window, but
17 it's random to prevent them from holding back
18 transactions that would be losers or whatever.
19 So, they don't know exactly the time we're going
20 to cut the prices. At the time that we cut the
21 prices, they don't know -- on any given day that
22 there are trades in transit; there are millions of

1 transactions that go through the process every
2 day, and so they don't know at what specific point
3 I snapped the picture of the transactions.

4 So, even if they had the ability to run
5 the books in the timeframe that is allowed for
6 them to make payment and assign all the trades
7 that they had to the appropriate customer accounts
8 and mark them to my specific prices, they still
9 wouldn't have the match of exactly what
10 transactions I had and what transactions they
11 have. So, there's no way for them to precisely
12 and accurately calculate what the deficit is for
13 any particular customer at that point in time,
14 particularly since for a lot of the very large
15 clients, a lot of the transactions are averaged
16 over the day and only assigned to their ultimate
17 home, the ultimate end account at the end of the
18 day.

19 So, there are lots of risk management
20 practices that go into the assessment of whether
21 or not these activities are posing risk to the
22 firms, as Ron was talking about. But the amount

1 of money that they pay the clearing house is
2 something that would be -- it's a practical
3 impossibility the way the business operates for
4 them to be in compliance with this calculation. I
5 mean, am I over --

6 MR. DAWLEY: Oh, that's spot on, and
7 that's just one example of many.

8 MS. TAYLOR: Right.

9 MR. DAWLEY: There are a lot of those
10 that need to be vetted, Bob, so, you know, I
11 commend you for holding this roundtable first of
12 all. I think this is a great exercise. We at FIA
13 and my firm have been very focused on enhancing
14 client protections. We drove the initial changes
15 at NFA and you and the CME blessed. So, I don't
16 want you to take what I'm saying the wrong way. I
17 just want you to know that this is a -- I've been
18 in this business for over 30 years. It's one of
19 the most monumental events that I've ever seen.
20 This one change to the model is so far-reaching,
21 and I'm just asking that the Commission appreciate
22 that and allow us to study it and come back to you

1 with more information, some of which will be in
2 our comment letter.

3 MR. WASSERMAN: So, let me make two
4 quick observations, then I'm going to give Michael
5 a chance, because he's been waiting.

6 The first is obviously one of the issues
7 that's very live here is to the extent any of
8 these changes -- you know, this change in
9 particular is adopted. Implementation is
10 something that, you know, the timing obviously
11 would be very relevant. And obviously it would
12 take some time, and one of the things that comment
13 would be helpful on is what sort of time would be
14 necessary?

15 Second, more generally, as you've heard
16 me say, Michael, Mike Dawley, many, many times,
17 the aim is how can we best achieve the regulatory
18 goal in a way that is the least painful, the least
19 costly to all concerned? I mean, I was about to
20 say to the FCM, but as Todd quite rightly pointed
21 out, ultimately it flows back to the customer.
22 And so in addition to -- and, you know, folks will

1 have comments on whether we should do this or
2 shouldn't do it. But what I would very much ask
3 is: To the extent that we do do it, are there
4 ways that we can reduce the cost? And so for
5 instance, hypothetically, you know, there's the
6 old Pareto ratio. If we could get most of the
7 benefit out of this, if we said this aspect, not
8 seg generally -- seg generally is, you know,
9 elsewhere in the rulemaking, it's clarified that
10 that is a continuous obligation -- but if this
11 aspect were, for instance, reduced to once a day
12 in the morning pay and so you have the overnight,
13 one might reduce some of the issues that Kim was
14 just talking about with terms of intraday collect.
15 And in addition to the regular intraday, there's
16 of course, well, CME and others have the right to
17 do intradays on an unscheduled basis in times of
18 particular stress. And so, is that a way -- you
19 know, again, in addition to the "gosh, this is
20 going to be very, very costly and we shouldn't do
21 it all," I would ask that you consider and perhaps
22 comment on: Are there ways we can do this and

1 essentially gain much of the regulatory aim but
2 hopefully significantly reduce the cost?

3 Let me give Michael and then Gerry.

4 MR. GREENBERGER: Well, all I was going
5 to say is that in this discussion I think there's
6 -- if I understand what you're saying, Bob, and
7 what I interpret it to mean is there's a shortfall
8 somewhere, and the shortfall has to be made up
9 some way. As a result of the meltdown when the
10 swaps market was not regulated, the shortfall was
11 made up by the American taxpayer. And one of the
12 principal protections of Dodd-Frank is the
13 American taxpayer. In the regulated futures
14 market, the shortfall has not been made up. Some
15 people say those are MF Global or one-offs and
16 Peregrine. But we have people at the table who
17 actively want to trade on futures exchanges, but
18 there's a large number of people who are at this
19 table who are abandoning trading on futures
20 exchanges. Why? Because when there's a
21 shortfall, either the taxpayer's getting hurt or
22 the small customers are getting hurt. And so I

1 think it is an imperative that we've got to fill
2 whatever the shortfall is. What we're being told
3 is the cost will be higher to the customer. But,
4 you know, I know a lot of customers who would have
5 paid a lot more money to get their MF Global seg
6 funds or Peregrine seg funds or in other
7 situations seg funds back. The customers are now
8 saying they'll pay for insurance. There may not
9 be an insurance scheme.

10 So, you know, Bob is absolutely right.
11 Somebody's got to pay for this. If somebody
12 doesn't pay for this and we have in the global --
13 now we have a swaps clearing facility, futures
14 clearing facility. If money is lost, those
15 ventures will fall apart.

16 I was here on February 29, 2012. D.E.
17 Shaw, CalPERS, I think CalPERS all said if our
18 money isn't going to be protected, we're not going
19 to trade swaps. So, that calculus has to be put
20 in place. Is there money missing from the system
21 that can lead to problems that will ultimately
22 shut down these markets? Maybe not completely,

1 but there will be a lot less. And I think you
2 just have to put that on the table. And I would
3 certainly say, you know, we know what the costs
4 are of not having proper regulation in the classic
5 futures market. It's disruption of the market.
6 If the same thing happened in the swaps clearing
7 market, there's even more discretion to pull away
8 from that market by the buy-side.

9 So, there are big costs to not doing
10 what seems to be -- needs to be done. We can't
11 have a system where nobody's paying for it. And
12 if we don't have collateral, we don't have
13 capital, we just go back to the meltdown
14 atmosphere where outsiders are going to have to
15 pay the cost or the insiders are going to be so
16 badly burnt that they move away from the markets.

17 MS. TAYLOR: Can I just comment on a
18 couple of things that Michael said here for a
19 minute?

20 MR. WASSERMAN: Gerry's going to be
21 next.

22 MR. CORCORAN: Thanks, Bob.

1 MR. ROGIC: I'd like to speak next,
2 after.

3 MR. CORCORAN: You know, obviously I'll
4 stipulate to what we're talking about here in
5 terms of where the bucket of the money is coming
6 from, but I do appreciate you providing us some
7 guidance on getting back to the Commission with
8 ideas and thoughts.

9 Part of the proposed language is talking
10 about real time measurements of this requirement,
11 and that's really, really difficult to do. As
12 Mike describes it, the ecosystem just can't handle
13 it right now. Some examples are that you just
14 can't get margining and settlement prices tick by
15 tick throughout the day, especially in the less
16 liquid markets. We're waiting for the exchanges
17 to, you know, close it up, run the span system,
18 assign risk arrays so we don't even know what the
19 margins are on a real time basis. Then we just
20 have, you know, globalization issues of real time
21 margining for accounts overseas that may not have
22 a U.S. presence that wire the money next day.

1 So, there are solutions to all that, and
2 the solutions, you know, generally come to
3 prepaying the margins. But if there was a basis
4 for, you know, creating a moment in time, so to
5 speak -- you know, a moment in time -- I think the
6 industry will have a better chance of getting
7 there. But wherever we go on this, and it seems
8 we all have an idea where we're going to end up,
9 it is going to be a timely process for FCMs to be
10 prepared to be in compliance and to change
11 behaviors of the customers.

12 Now, let me give you an example for RJ
13 O'Brien. I would say, without any scientific
14 data, we are probably the largest clearer of
15 ranchers and farmers in the industry and probably
16 one of the largest clearers of speculative retail
17 investors.

18 In the terms of ranchers and farmers, in
19 some cases if we require them to wire their margin
20 every day, the banking costs will be in far excess
21 of the commissions they actually pay RJ O'Brien.
22 This will be a very, very costly impact to farmers

1 and ranchers to meet their daily margin
2 requirements. So, how will we avoid that? We'd
3 have to prepay margins for a few days.

4 Also, in our case it may sound archaic
5 to some of those who may hear this, but last year
6 we still processed 50,000 checks for retail
7 clients that meet their margin calls. And we've
8 done everything we can to accelerate the
9 collection process using scanners and such to make
10 the funds good, but that still is a gap in the
11 funding measure to meet the proposed rules.
12 People could still send checks, but they'd have to
13 maybe double or triple their margin requirements
14 so that the next time they send in a check there
15 are more than adequate funds in the account.

16 So, there are ways to address it but it
17 will have meaningful impact. I'm trying to give a
18 couple of real world examples there so you guys
19 can understand it from maybe a mid-size firm that
20 deals with farmers, ranchers, and retail clients.
21 It's difficult, and I would say when we look at
22 our data in terms of our excess seg matching up to

1 the required margin requirements, it's a
2 statistical outlier for us to miss it. But when
3 you miss it, you miss it because of an event, and
4 you can't run your business guessing when an
5 outlier event's going to occur. So, you have to
6 be prepared for it each and every day, which means
7 we'll have to have prepaid margin requirements on
8 the books to make sure we have adequate funds.

9 So, all of that is doable. It all comes
10 with a cost. We've described that ad nauseam
11 here, but, again, trying to give you some real
12 time examples from our perspective on how that
13 would work.

14 MR. ROGIC: Thank you. I'm Predrag
15 Rogic from T. Rowe Price. Appreciate the
16 invitation to participate today. It's a very good
17 discussion.

18 We fully support the Commission's
19 efforts on enhanced customer protections, and it's
20 very enlightening for me to learn today -- similar
21 to what Bill was saying, as a mutual fund firm we
22 typically use futures for various purposes,

1 primarily to hedge interest rate risk, bond
2 portfolios, and other uses; and we typically post
3 excess margins, so we would be in the category of
4 customers that have excess margin at all times --
5 and I'm, I guess, enlightened and also a little
6 bit worried to learn how much at risk that excess
7 margin is and apparently sort of the foundation of
8 the whole system, that excess margin customers are
9 now subsidizing many more customers that are
10 apparently, you know, trading without satisfying
11 their requirements on a timely basis or on a
12 periodic basis.

13 So, it would be -- I know that, you
14 know, the proposal has some thoughtful -- the
15 release has very thoughtful analysis, and
16 obviously the need for data is obvious, and
17 hopefully, you know, I was hoping we would hear
18 some more concrete numbers today. But I think the
19 targeted residual interest concept is a good, you
20 know, step in the right direction where it would
21 sort of force FCMS to do a credit analysis to
22 differentiate between customers, assess customers'

1 risks, and sort of allocate their margin
2 requirements appropriately between customers so
3 that where you have customers that may be posing
4 higher risks would have enhanced margin
5 requirements and those customers that are
6 regularly posting excess would not bear the full
7 risk of the whole system functioning essentially
8 without any compensation. So, that's --

9 MR. WASSERMAN: Kim and then Josh and
10 then back to Gerry and then Ron.

11 MS. TAYLOR: I just had wanted to
12 respond to a couple of the comments that Mr.
13 Greenberg was making. I have to challenge pretty
14 significantly the idea that you seemed to be
15 putting forth, all due respect, that the taxpayers
16 somehow bailed out the futures industry. In the
17 midst of the depths of the meltdown, no taxpayer
18 ever spent one dollar to bail out the futures
19 industry. The futures industry survived that
20 event with flawless outcome, and we suffered the
21 default or the bankruptcy of a very large provider
22 of services in that process. And another very

1 large participant in the markets also went out of
2 business and was a clearing member at CME, and
3 that was not any part of a bailout. So, that's
4 the one thing I just wanted to kind of call out.

5 The other thing is the context for the
6 problem that you're talking about. There was a
7 shortfall with MF Global. There was a shortfall
8 with Peregrine. Those shortfalls were caused by a
9 very particular thing. They were not caused by
10 the failure of one customer to, the next morning,
11 meet its margin call from today's activity. They
12 were caused by inappropriate treatment of customer
13 funds by the parties at those firms. There have
14 been a lot of changes in the industry that have
15 taken place to help protect against that.

16 What the residual interest proposal is
17 effectively addressing is more or less a problem
18 of kind of bad debt allowance. It is forcing an
19 FCM to, dollar-for-dollar, reserve for the
20 potential for there to be a bad debt the next
21 morning when it collects margin calls. And we can
22 do that. It may be that it's the right decision

1 for the industry to that. But if you look at the
2 way banks treat that problem, even under Basil III
3 banks are not required to, dollar-for-dollar,
4 reserve for loan losses. I think they probably
5 are reserving 7 or 8 percent. So, it is a very
6 different problem that we're trying to solve here
7 than the problem of MF Global or Peregrine.

8 MR. GREENBERGER: If I may be permitted,
9 I never suggested -- I could see how what I said
10 may have been confusing. I never suggested that
11 the futures industry needed to be bailed out, and
12 you rightly should be very proud of that. But the
13 swaps industry had to be bailed out. Credit
14 default swaps were uncollateralized, naked credit
15 default swaps, and uncapitalized. That's what I
16 was talking about.

17 Secondly, what has happened and what I
18 was referring to is MF Global and Peregrine
19 together have caused a lack of confidence in the
20 futures industry. And when I looked at the
21 figures last -- and I must admit I haven't looked
22 at them in the last few months -- the futures

1 trading was way down. People are backing away
2 from the futures industry. So, the point is if
3 there -- and you, to make the point that what the
4 regulations are trying to address were not the
5 problems in MF Global or in Peregrine.

6 But as Bob keeps saying, as I understand
7 it, it is a problem. Bad debt is a problem. And
8 you can very quickly run into problems. And all
9 I'm saying is if you want to have a lot of
10 business at the CME and the clearing houses want
11 to have a lot of business for swaps, there'd
12 better not be shortfalls, because whatever these
13 figures are for costs, swaps trading will dive,
14 and if there's another MF Global because of a
15 short-term bad debt, your business will dive. I'm
16 not saying that you don't do great work, but we
17 see when there are shortfalls what happens.

18 In the futures industry, it wasn't the
19 American taxpayer, but it was a lack of confidence
20 in trading that has damaged not only the futures
21 side but the swaps side.

22 MR. WASSERMAN: Josh.

1 MR. COHN: Thank you. I think I'm
2 picking up actually on something that Kim was
3 raising. What we're focusing on is not all risk
4 or risk over long periods of time with a residual
5 interest proposal. We're focused on intraday
6 risk, and it's possible that we're seeing -- as
7 people talk about the costs associated with
8 intraday risk or the logistical problems -- we're
9 seeing that there's a great burden associated with
10 easing an intraday risk problem. And I'd simply
11 ask that as the agency considers cost and benefit
12 it focus on exactly the nature of the risk that
13 it's seeking to diminish.

14 Just to touch on Bill's point about
15 same-day collateral transfer, speaking as a swaps
16 lawyer, I wish we could always get it even in
17 swaps land, but we can't, and people can't always
18 do it even after they agree with it. So, I would
19 just suggest that people take that suggestion in
20 an appropriate context.

21 And last, of course, as a representative
22 of the swaps industry, I would suggest that Mr.

1 Greenberger's depiction of the role of the swaps
2 industry and the financial crisis is somewhat
3 overstated. (Laughter)

4 MR. WASSERMAN: Gerry?

5 MR. CORCORAN: Just two quick comments.
6 To the extent that Bill and Predrag -- you know,
7 it's not in every situation that you're overfunded
8 situation is meeting the calls --

9 MR. ROGIC: Right.

10 MR. CORCORAN: -- of the others. As I
11 stated in RJO's case, it almost very seldom
12 happens on an outlier event. And maybe that's too
13 much, but I don't want the perception coming out
14 of this room today that, like, all FCMs are
15 running their businesses on the backs of the
16 customers with excess funds, because it's far from
17 true. Far from true. And so I think that is
18 something I just wanted to put out there.

19 And, secondly, although due respect to
20 my partner here, you know, at RJ O'Brien we don't
21 see a lack of confidence in the futures industry.
22 Our business has continued to grow. And I think

1 the futures industry volume that has dropped in
2 the last year is really from the interest rates
3 base, and we all know what's going on with
4 interest rates. So, I feel a little bit
5 differently. I feel that the industry as a whole
6 and consumers and customers really believe that
7 the NFA Rule 16, the transparency in the bank
8 accounts that's being done by the NFA and the CME,
9 has bolstered the confidence levels of the
10 industry well above the levels they were after MF
11 and PFG, and industry continues to work on the
12 transparency and continues to safeguard customer
13 assets. That's why we're here today as well.

14 SPEAKER: One point -- go ahead.

15 MR. DAWLEY: I would just add that
16 there's a lot we have to be proud of. I mean,
17 there have been a lot of great things that have
18 enhanced customer protections. But I do think
19 that the return starts to diminish. You can only
20 go so far. And once again, I commend you, Bob,
21 for holding this roundtable. I think we need
22 more. I think education continues to be needed

1 throughout the industry. I mean, just the
2 understanding of how the gross omnibus model works
3 or the lack of the understanding of that model is,
4 I think, prevalent. So, I think we need to
5 educate folks.

6 MR. WASSERMAN: Before I go to Ron and
7 then Dale and then Bill, I'm no expert in the
8 specific volumes that have been trading in the
9 futures industry or explanations. I'm just a guy
10 who comes around to the bankruptcies. (Laughter)
11 And I will say that, you know, we've gone for
12 quite a long time without any losses in the
13 futures account. And, yeah, we had Griffin. That
14 was 30.7, whatever. We had two of these in a
15 relatively brief time period, and I've got to tell
16 you based on -- and, you know, maybe I'm just
17 talking to folks who are very concerned about
18 bankruptcies, but I've got to say if a third one
19 of these happens any time soon -- and I don't care
20 what the reason is, and I don't think they're
21 going to care whether it was because of a repeat
22 of what happened at MF or a repeat of what

1 happened in Peregrine or something new -- I've got
2 to think that the confidence of the folks out
3 there on the buy- side is going to be really,
4 really shaken. They don't want to know why. They
5 want us to make sure that it does not happen. And
6 I guess that's sort of the perspective coming from
7 the bankruptcy guy.

8 Ron?

9 MR. FILLER: Thank you, Bob. I share
10 your concerns. I don't think anyone loves this
11 industry more than I do, but let's be honest.
12 These proposed rules, which are great for customer
13 protection, would not have prevented Peregrine or
14 MF Global, as Kim mentioned. And I think the best
15 thing that's providing protection to Peregrine/MF
16 Global is the new gross margin rule where there
17 are less monies being held at the FCM and more at
18 the DCO level.

19 But to go back to your question before
20 about wanting some examples, I'm a big believer
21 that the residual interest should be left to the
22 objective discretion of the FCM, and they should

1 disclose the amount of the residual interest. And
2 I'll give you an example. When I was at Lehman,
3 we had a large money manager who had hundreds of
4 accounts decide to transfer their positions from
5 one FCM over to Lehman. And we calculated the
6 initial margin to be about \$125 million. And as
7 we all know, when the positions come over, the
8 money doesn't come over for a day or two later.
9 And I instructed our treasury to put \$250 million
10 into the seg fund as our residual interest just to
11 be at a comfort level that we would not fall and
12 that when the monies did come over within the next
13 24 or 48 hours I then authorized the Treasury to
14 now withdraw that \$250 million. Now, today, if
15 that would have been more than 25 percent, I would
16 have had the CEO or the CFO issue that report.
17 But, I mean, FCM's do manage these assets in a
18 proper way, and all those funds that we're
19 involved with in that (inaudible) transfer all
20 were traded, already open positions on and a
21 change and clear, and I knew we would not get the
22 money to fund those positions for 24 to 48 hours.

1 I think you need to work with the FCM community to
2 try to, you know, you have confidence, and as Kim
3 mentioned, the MF Global and Peregrine -- we know
4 the facts behind it, and with Peregrine we know it
5 was just absolute fraud. I mean, I was on the
6 special committee at NFA to just issue that report
7 and, you know, we know it was fraud on the part of
8 the principal there, and no rule and no
9 regulation, unfortunately, is going to prevent
10 that type of fraud. In fact, he was taking
11 customer funds and putting them back in his
12 capital to the FCM and creating a residual
13 interest using customer funds. That's what part
14 of the facts were. And I think we need to look at
15 these and go with these and give some discretion
16 or judgment to the FCMs in regard to the amount of
17 residual interest that they should have.

18 MR. SPOLJARIC: Yes, thanks, Bob. Just
19 to expand on some of the things that everybody's
20 been alluding to, and we've talked a lot about the
21 increased costs. And the solution may be some
22 iteration of the proposed residual interest

1 computation. But what I think can't be discounted
2 here are some of the other enhanced customer
3 protections that have been put into place, such as
4 the regulation 1.73 that would require pre-trade
5 risk checks. Ron alluded to the customer gross
6 margin where the FCMs are actually forced to put
7 up margin on a gross basis with the DCO. And I
8 think those things, when looked at in the big
9 picture, do go a long way to decreasing fellow
10 customer risk.

11 MR. WASSERMAN: Bill?

12 MR. THUM: The place that I come from
13 is, you know, not the futures world; it's the
14 swaps world. And while we do have same-day margin
15 transfer, at Vanguard, being a registered fund, we
16 also have our margin held by a custodian. And,
17 you know, there's no risk at all. It's the
18 business, you know, and when Lehman went down we
19 got the margin back from the custodian.
20 Everything was fine.

21 Vanguard's been a big supporter of LSOC
22 to try to find a half-way solution between the

1 futures model and the swaps model but certainly on
2 the buy-side and other asset managers and
3 registered funds don't think LSOC went far enough,
4 you know, and are so suspect of the futures model
5 that there is a very large active group meeting, I
6 would say, every other week to come up with a
7 tri-party or quad-party model to take all the
8 margin out of the system and have it held by a
9 custodian.

10 So, that's the level of passion and
11 concern, I think, associated with a futures model.
12 You know, maybe it's not rational; it's certainly
13 not what Vanguard was arguing for in support of
14 LSOC. But there is a very large, active group,
15 which includes hedge funds, real money managers,
16 and others that are still pursuing these
17 alternatives to LSOC. So, I think we have to keep
18 that in mind when we look at this.

19 I think, Bob, your suggestion of are
20 there other ways to "skin the cat" that achieve
21 many of the benefits without some of the costs.
22 You know, it's a good way to think about it. And

1 I certainly urge those around the room that are
2 much more familiar with the operational
3 complexities of running your business that there
4 may be proposals that the CFTC should hear and may
5 be more workable.

6 You know, from my perspective, the
7 businesspeople of Vanguard and I think certainly
8 our shareholders are watching this space very
9 carefully. They know our positions to date. They
10 know we're advocating for the margin to be
11 protected. They do not want to see our margin
12 used for any reason, and even to get a hint that
13 it's being used to margin other customers is
14 beyond something they can accept.

15 So, this rule, while it is a fundamental
16 shift in the futures market, is, you know,
17 approaching something that our shareholders have
18 enjoyed in the over-the-counter non-cleared swaps
19 market since we've begun trading. So, I think
20 that while we need to achieve it, perhaps we can
21 look to achieve it in a more workable solution.
22 And I would be interested to hear what those

1 proposals are.

2 MR. WASSERMAN: And, yeah, I very much
3 appreciate that.

4 Before I give it over to Kim, I would
5 make two quick observations, one of which is that
6 as we had discussed over quite a few meetings over
7 the course of this summer, this is indeed
8 happening on the swap side; that is to say, this
9 calculation is being made and is happening every
10 day. Really, the issue we're confronting here,
11 and just in terms of measuring costs and providing
12 data, is essentially codifying this on this
13 futures side, because that is, as Mike Dawley
14 quite rightly pointed out, a shift in that
15 ecology.

16 The second is it's happening -- you
17 know, again, this money is coming from somewhere.
18 It's coming from customers who are posting excess,
19 and a very real possibility, you know, even if we
20 don't do this, is that that excess ends up getting
21 shaved. And I think there are number of ways in
22 which larger folks are pushing in that direction

1 and may even be even more so as -- you know, I
2 couldn't be here for the futurization roundtable,
3 I was up on MF Global in New York, but as we start
4 seeing some swaps being futurized, the issue of
5 how we handle this on the futures side becomes
6 more important. It would be really sad I think if
7 the only folks who had excess up and whose excess
8 was being used were the small customers, because
9 then when, Heaven forfend, the next one of these
10 happens, I've got to tell you, we'll be really
11 hearing it, and rightfully so, from the folks who
12 supervise us on the Hill.

13 And so Kim.

14 MS. TAYLOR: First I just wanted to
15 follow up on something that Bill mentioned about
16 the moves to have further enhanced customer
17 protection in the swaps arena beyond LSOC. We're
18 very supportive of those efforts also as an option
19 and working with various parties in the industry
20 to try and pursue workable alternatives there.

21 But then before -- I thought our time
22 was kind of winding to an end, and before we

1 really ended I wanted to --

2 MR. WASSERMAN: This is until 5.

3 (Laughter)

4 MS. TAYLOR: Oh, okay. I wanted to
5 bring up some issues of a slightly more technical
6 nature that I just think we need to get out on the
7 table, that there are some things --

8 MR. WASSERMAN: Please, please.

9 MS. TAYLOR: -- that if we were going to
10 move forward this, there are several things that
11 when put together don't make sense when put
12 together. And the biggest example, I think, is
13 the fact that if the FCMS are fully funding the
14 margin calls with the residual interest
15 calculation, then why is there a need to take a
16 capital charge in one day, because they've already
17 taken a full hit for the full funding. So, that
18 seemed duplicative.

19 Also, I would suggest that we think
20 about the fact that there's a very kind of -- the
21 target residual interest amount that FCMS are
22 required to put out seems to be a number that is

1 kind of set in stone and it seems to be -- I
2 perceive in reading the thing that there's a
3 penalty for falling below your target residual
4 interest amount. And it might be that it makes
5 more sense to allow there to be the target
6 residual interest amount to absorb some of the ebb
7 and flow of the need to fund the margin calls
8 every day, so that you don't need to have your
9 kind of excess residual amount on top of being
10 fully funded for the margin calls. That's the way
11 I read it. I don't know if that's the way you
12 guys read it.

13 And then it also would seem to make
14 sense -- and this is kind of going to something
15 that Jerry was saying about having to build your
16 business and plan and charge your customers as if
17 every day you're planning for the worst day your
18 business might ever suffer. It might make sense
19 for there to be some kind of a safe harbor for the
20 way that you calculate the amount of residual
21 interest that you need to be able to fund on any
22 given day based on, you know, some kind of measure

1 of historical activity so that you don't have to
2 operate your business every day as if the very
3 worst thing that ever happened might happen. But
4 you get to have some kind of normal funding
5 element that is at play, because on a day when the
6 worst things are happening, that's the kind of day
7 where I think it's more likely that firms exercise
8 their ability to do same-day intraday calls to
9 clients anyway. It's when things are -- when the
10 markets are behaving very abnormally.

11 MR. DAWLEY: Some of the early data we
12 got back really point to what Kim just mentioned.
13 The numbers get quite large.

14 MR. WASSERMAN: So, before I give it
15 over to Jim and then Dale, on your second point,
16 my understanding is that the intention is that the
17 residual interest essentially -- and this is
18 something I guess Ron had mentioned earlier --
19 it's not one on top of the other but, rather, you
20 need to have a target residual interest, and you
21 also need to make sure that that residual interest
22 covers the margin deficiencies if that's -- in

1 other words, it would end up being the greater of
2 those two rather than the sum. So, just --

3 MS. TAYLOR: I think it reads like the
4 sum, but --

5 MR. WASSERMAN: And again -- I'm going
6 to reemphasize again that in your comment letters,
7 if there are things that we've said that have been
8 imperfectly expressed or could be made more clear
9 or could be untangled, please, please, please give
10 us the specific provision, ideally, specific
11 language -- you know, we want to get it right,
12 we're human, but if you can help us get it right,
13 I think we're all better off. And, so, Jim and
14 then Dale and then Predrag.

15 MR. KOUTOULAS: Historically, it's been
16 my understanding that the firm excess component is
17 really designed to serve as a buffer in the event
18 of a customer blowup or something. So,
19 historically, in the question of who's paying for
20 something like this I think has been the firm
21 excess. And I can't seem to find the rule number
22 here in my notes. But one of your proposed

1 changes -- question: Should we have a
2 quantitative standard for what firm excess should
3 be? And I think we should. And I think that
4 should be formulaic and in an easily
5 understandable manner that perhaps takes into
6 account both the amount of segregated funds on
7 deposit and also if there's proprietary trading
8 being done that could use that firm excess is
9 essentially to back that firm excess and, you
10 know, call it something similar to span. But if
11 there's a system where people know exactly what it
12 is you still have the firm excess to essentially
13 allow FCMS to extend credit on a short-term basis
14 to customers and back those for a day or two. I
15 think that could take a lot of the pain that would
16 go with these other margin calls shortening
17 restrictions but still achieve the same result.

18 MR. SPOLJARIC: Yes, thanks, Bob. Just
19 to add one technical issue to Kim's list, and I
20 know this has been discussed with Commission staff
21 in the past, but as it relates to the computation
22 of the residual interest covering the margin

1 deficits, there is the potential that certain
2 balances would be double counted as it's proposed
3 in the regulation, in particular, those accounts
4 that maintain both a margin deficiency and an
5 equity debit. So, the side computations for
6 residual interest purposes already factor into
7 those situations where variation margin exceeds
8 the financial wherewithal of a particular
9 customer's trading account. That is, dollar for
10 dollar, eaten into the residual interest of the
11 firm, and the purpose of the buffer to begin with.
12 So, I think that that language of what a margin
13 deficiency is for purposes of this would need to
14 be clarified to avoid that double counting.

15 MR. ROGIC: Yes, just also following up
16 on what Kim had said, it seems like -- I also read
17 the targeted residual interest calculation to be
18 up to each FCM to calculate, given the
19 methodologies that it puts forward subject to
20 review by the Commission but the minimum required
21 amount is the aggregate of the deficits, right?
22 So, given that clarification, I mean, it seems to

1 me like you're saying that that will be workable
2 and it will achieve that covering the ebb and
3 flow, which would then alleviate this problem
4 we're trying to work out here, that --

5 MS. TAYLOR: You'll get some of it.

6 MR. ROGIC: Some of it. But it seems
7 like a step in the right direction. I think that
8 was kind of intended. It also seems there are
9 ways to do this without maybe, you know, doing
10 tectonic shifts in the whole ecosystem. So, I
11 just wanted to make that observation.

12 MR. WASSERMAN: Mike.

13 MR. DAWLEY: Bob, just to share with you
14 some of the other things we've been thinking
15 about, and you can have confidence that the entire
16 industry is focusing on this.

17 One of the areas is timing differences.
18 That's really at the crux of this problem. It's
19 really not the need for an FCM to utilize funds
20 for one client versus another. It's really about
21 how do we manage these timing differences. And
22 the timing differences aren't that long, right?

1 If you think about it, if you incorporate the
2 midday intraday variation, it really is the
3 difference between them and the close of business
4 the next day, which is really the period where
5 you're in essence funding something and then
6 needing to collect from customers.

7 So, moving around some of those
8 settlement times is something we've been throwing
9 around. It does get challenging, because in some
10 respects you might be moving risk from one spot to
11 another. For example, I mean, I don't know how
12 Kim would feel about this, but if the clearing
13 house debited the FCMS at 3 o'clock in the
14 afternoon on T+1, that would give the FCMS all day
15 to collect, and whatever they didn't collect they
16 would fund. But I'm sure with Kim here and her
17 clearing house hat on and her responsibilities
18 there --

19 MS. TAYLOR: I think that will make your
20 guarantee fund go up.

21 MR. DAWLEY: Exactly. (Laughter) But
22 it's all a part of the same equation, right?

1 Where do you fill the gap? There are so many
2 places you can fill this gap, and I think it's
3 really important to figure out what is the most
4 cost-efficient and reasonable solution, and
5 there's -- you know, is it the clearing houses
6 just doubling margin? Is it FCMs going out and
7 getting funding? And is it the FCMs increasing
8 margin over and above exchange minimum, which
9 could also have unintended consequences? You've
10 got FCMs competing on margin. You know, there's
11 just a whole host of things that one could do to
12 fill the gap, but they're all going to cost money
13 at the end of the day. I think that's the
14 important thing for everyone to know.

15 I mean, just to give you one other
16 comment on some numbers, early numbers. These are
17 far from final, but it's just in the U.S. futures
18 realm alone. The increases could be as much as
19 \$80 billion of additional funds needed, and
20 whether you apply that via higher margins or you
21 have a need to go out and finance it, you know,
22 that's a lot of money at the end of the day and,

1 you know, one percent on 80 billion is a pretty --
2 that's like three or four FCMs' total profits.

3 So, these are some pretty big numbers.

4 MR. WASSERMAN: And I appreciate those
5 numbers. I guess one question, and I think this
6 came up just a few moments ago. In doing the cost
7 analysis, first you guys should do whatever cost
8 analysis you think is proper. Let me put one
9 thing out on table, which is the intention of the
10 rule as I understood it, and again we may need to
11 clarify how it's expressed, is that the residual
12 interest should be at least large enough to cover
13 the margin deficits. Today I'm not aware of any
14 FCMs who clear customers who don't have at least
15 some residual interest in there, and indeed they
16 really are targeted. And so in analyzing the
17 cost, it strikes me -- but you will have to form
18 your own views -- that you would -- the question
19 is: What is the marginal residual interest that
20 would need to be there to meet this? To the
21 extent that you have an FCM whose residual
22 interest already covers their customers' margin

1 deficits, there's no addition there. Or maybe I'm
2 missing --

3 MR. DAWLEY: One more stat for you, and
4 this will all be in the FIA's comment letter but
5 just to give you an idea of what we're seeing.
6 Five or six FCMs -- they're all anonymously
7 portrayed in the data, but, you know, as you know,
8 the historical reason for a question or residual
9 interest has been to cover liquidating deficits.
10 And then there's a subjective component that is
11 meant to cover for operational error, anything
12 just to ensure that you're comfortable that you're
13 not going to be in violation and go under seg. If
14 we apply that same model to margin deficits those
15 five or six firms that we looked at, their
16 historical need based on liquidating deficits,
17 moving the margin deficits ranges from anywhere
18 from 68 times to 286 times the amount of capital
19 they would need. So, if you needed \$2 million
20 today, the firm that's at 268 times needs, you
21 know, you can do the math. It gets pretty big.
22 So the margin deficits are always going to be

1 substantially higher than liquidating deficits.
2 That's where the big spin comes from.

3 MR. WASSERMAN: Fair enough, although
4 again the question is: So are we really having
5 firms who are permitting their clients to
6 undertake margin deficits that are 68 times their
7 excess seg, and we all know where that money is
8 coming from -- I mean, this is the dilemma, right?

9 MR. DAWLEY: Yeah.

10 MR. WASSERMAN: There's a cost issue,
11 very, very real. We need to understand it. We
12 need to analyze it. But the more we're talking
13 about the cost issue, it's got to be -- right now
14 we're not -- most of this is not friction cost;
15 it's a shift from -- at least I think so, and you
16 will form your own views and express them in your
17 comment letters -- from where I'm sitting, this is
18 an issue of who's bearing that, who's bearing --
19 and is it the FCM, or is it the customers who are
20 posting excess? And so if what you're saying is
21 well, there's a whole big bunch of more money
22 that's going to need to come in, that means

1 there's a whole big bunch of money of fellow
2 customers that's currently being relied on to
3 margin the positions of those customers who aren't
4 prefunding.

5 MR. DAWLEY: You're absolutely right,
6 and that's really -- the stats are meant to give
7 you an indication as to what will need to come
8 into the system, which has been in existence for a
9 long time. And I think you have to just think
10 about it as this timing gap, right? It's that
11 period of time where FCMs have been hit for
12 settlement and they need to go out and collect
13 money. So, it's -- I think it's being portrayed
14 as something a lot worse than I think it really
15 is. All these assets are segregated, so it's, you
16 know, it's not a seg issue. It's just -- it's a
17 funding issue for a period of time. And we have
18 to solve for it. Nobody's denying that. It's
19 something that I think is the challenge before us.

20 MR. WASSERMAN: And again, speaking of
21 the timing gaps, speaking purely for myself,
22 please do analyze to what extent the cost issue

1 could be mitigated if we made this a once-a-day --
2 and, I'm sorry, not at 3 p.m. But at 9 a.m, 8
3 a.m., when the beginning of the day, essentially,
4 margin call is made and looking at that as the
5 beginning of the new day's clearing cycle. If we
6 were to make this requirement applicable at that
7 time rather than vis-`-vis intraday, to what
8 extend would that mitigate the cost issue?

9 MR. DAWLEY: And I think that, you know,
10 maybe 3 p.m. is too late, but I think it's an area
11 of -- and I think 9 a.m may be too early. It's
12 depends on the client types one is servicing. I
13 mean, Gerry with his thousands of checks may be
14 more challenging, but most big institutional
15 client settle fairly early in the morning and
16 would be able to meet their calls which could put
17 a huge dent in the funding requirements if we had
18 more time to collect.

19 MR. NUNERY: I want to build on
20 something that Bob was just saying just a moment
21 ago. When evaluating this rule from a cost
22 benefits standpoint, one of the things that would

1 be very interesting to understand is to what
2 extent are the costs that we're talking about here
3 new costs? And to what extent are they costs that
4 are currently being borne by other market
5 participants, albeit perhaps unaware of bearing
6 those costs? And any perspective that you can
7 give us on that point -- to what extent are the
8 costs new versus to what extent are the costs
9 being shifted from one group of customers to
10 another -- would also be very helpful to
11 understand.

12 MS. TAYLOR: Let me give you one example
13 of how I think it's new, and correct me if I'm
14 wrong here, but I think that the idea of the
15 margin calls being unfunded -- I think before
16 there was gross customer margining -- and so
17 pretty much every dollar you collected from the
18 customers needed to be passed through to the
19 clearing houses -- there was a significant portion
20 of the funds that were held back and not passed
21 through and just were held by the FCMS, and if the
22 margin call wasn't met, then that wasn't part of

1 seg funds, it wasn't part of the obligation you
2 had to the client because you weren't holding
3 anything. So, I think, actually, customer gross
4 margining is a new element in the landscape that
5 probably affects whether these costs are kind of
6 realized or not. I think that changes things.

7 MR. WASSERMAN: In fairness
8 analytically, those costs have been incurred in
9 the sense that gross margining is now a
10 requirement.

11 Cam, if I'm right, I think the issue is
12 for this rule, in this rulemaking, which of the
13 costs are new versus -- is that the correct
14 analysis?

15 MR. NUNERY: Yeah, I think so. I mean,
16 there are certain costs that are -- if you'll just
17 -- again, with the caveat that this is my opinion,
18 not the Commission's opinion, and there's some
19 time to be reflected on some of these things, but
20 it strikes me that there are certain costs that
21 are obviously new.

22 So, new infrastructure costs, you know,

1 those sorts of things are obviously in addition to
2 what is necessary today. But when we talk about
3 the costs that are associated with the additional
4 margin that would be required in order to meet the
5 terms of this rule, as we've been discussing thus
6 far that margin comes from somewhere, and in
7 today's system that margin is coming from the
8 excess of other customers who have excess in their
9 accounts. And so the question occurs to me: To
10 what extent are the costs of that additional
11 margin considered new, vis-`-vis the current
12 situation it's in? You know, it's an open
13 question. I would love to have feedback on that
14 both now and in the comment period as well.

15 MR. DAWLEY: I'll give you a quick
16 opinion. I feel they're new, even the ones you
17 just described. I mean, if you think about how
18 the system is structured, a global FCM has one big
19 omnibus account, and they're using those funds to
20 meet obligations all over the world -- some, you
21 know, 65 clearing houses all over the world -- and
22 that's just how the system works. It's actually

1 quite innovative. The entire system is
2 segregated, so you move money around the planet,
3 but the clients that are contributing funds into
4 that pool are in fact getting paid interest, so
5 what they see is a balance sitting with their FCM
6 and they see interest credited to their account,
7 which was a negotiated item. So, in that respect,
8 I think, you know, I think these are news costs,
9 because there's really -- it's not like -- if
10 we're saying that one client is funding another,
11 could you say that they should get paid for that?
12 Well, they're already getting paid via the
13 interest that was negotiated. So, the new costs
14 will really come in many forms, and I don't think
15 we've figured that out yet. If the margin
16 increases, what's the cost to that? I don't think
17 we know yet that that will differ by client type.
18 If there are financing costs and the FCM has to go
19 out and obtain capital to, in essence, top up the
20 residual interest, that's going to vary by firm.
21 Everybody's going to have a different cost to
22 funding. What they'll pass back to their clients

1 could vary. Some firms may choose to absorb that
2 cost; others may not. And then, lastly, you can
3 have clients prefund, which is similar to
4 increased margin, but there's a cost associated
5 with that, too, and that's going to vary by
6 client. But I do -- to answer your question, I
7 think all these costs are new.

8 MR. WASSERMAN: Let me ask something,
9 Mike. So, there are customers, of course, who are
10 essentially posting excess, and some of them may
11 and some of them may not -- and it's a negotiated
12 item -- get a return based on that. I guess, to
13 what extent are they looking at this. To the
14 extent they are aware of it as well, this is my --
15 what I'm getting for taking on the risk of 1.25
16 assets, and to what extent is there essentially a
17 marginal risk of insolvency loss because their
18 money is being used essentially to fund a margin
19 timing problem. And so isn't there a cost for the
20 -- to the extent we're permitting this, isn't
21 there an implicit insolvency risk cost that is
22 being borne by those customers who are posting

1 excess?

2 Well, and we're at 4:59. Wait -- Ron?

3 MR. FILLER: Before we close, I have a
4 suggestion for the next roundtable. And since you
5 and I are both bankruptcy geeks, I think we need
6 to focus on 190 and changes to 190, and I highly
7 recommend that the Commission consider doing
8 something in that not too-distance future, a
9 roundtable talking about part 1.90.

10 MR. WASSERMAN: We definitely need to
11 address 190, and as soon as I can. (Laughter).
12 Thank you all very, very much. Again, I'm going
13 to reemphasize that comments that are specific --
14 again, if you don't like something, and I know
15 there are many things that many folks here don't
16 like, you should say so. If you do like it, say
17 so. But in particular, as well, if there are
18 clarifications that we can do, be as specific as
19 possible. If there are ways we can tweak things
20 to make them less costly and yet still achieve the
21 goals, please suggest those. Again, the more
22 detail on those kinds of things, the more

1 specifics, the more helpful it is for us and
2 hopefully the better a job we can do for all of
3 you.

4 Thank you all very, very much.

5 (Whereupon, at 5:00 p.m., the
6 PROCEEDINGS were adjourned.)

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

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