

Capital Reporting Company
Commodity Futures Trading Commission Public Roundtable 01-31-2013

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COMMODITY FUTURES TRADING COMMISSION
PUBLIC ROUNDTABLE ON FUTURIZATION OF SWAPS

Thursday, January 31, 2013

Commodity Futures Trading Commission

1155 21st Street, N.W.

Washington, D.C.

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1 A P P E A R A N C E S

2 PANEL 1

3 CFTC MEMBERS:

4 AARON BRODSKY

5 FRANK FISANICH

6 EVE GUTMAN

7 ABIGAIL KNAUFF

8 NANCY MARKOWITZ

9 SCOTT MIXON

10 RICHARD SHILTS

11 ANANDA RADHAKRISHNAN

12 DAVID VAN WAGNER

13 PANELISTS:

14 PAUL CAMPBELL

15 BRYAN DURKIN

16 TOM FARLEY

17 CHRIS FERRERI

18 GEORGE HARRINGTON

19 CLIFF LEWIS

20 WALT LUKKEN

21 JEFFREY MARON

22 LEE OLESKY

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1 A P P E A R A N C E S (Continued)

2 JOHN PARSONS

3 WILL RHODE

4 DEXTER SENFT

5 DON WILSON

6 PANEL 2

7 CFTC MEMBERS:

8 ANANDA RADHAKRISHNAN

9 TRACEY WINGATE

10 PANELISTS:

11 NEAL BRADY

12 JAMES CAWLEY

13 TOM FARLEY

14 JACK HATTEM

15 DANIEL MAGUIRE

16 DAVID OLSEN

17 SEAN OWENS

18 KIM TAYLOR

19 DON WILSON

20 LUKE ZUBROD

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1 A P P E A R A N C E S (Continued)

2 PANEL 3

3 CFTC MEMBERS:

4 AARON BRODSKY

5 EVE GUTMAN

6 ABIGAIL KNAUFF

7 NANCY MARKOWITZ

8 GEORGE PULLEN

9 MICHAEL PENICK

10 RICHARD SHILTS

11 SAYEE SRINIVISAN

12 DAVID VAN WAGNER

13 NHAN NGUYEN

14 PANEL MEMBERS:

15 NEAL BRADY

16 TOM CALLAHAN

17 JAMES CAWLEY

18 BRYAN DURKIN

19 WILLIAM EMMITT

20 TOM FARLEY

21 SUNIL HIRANI

22 JERRY JESKE

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1 A P P E A R A N C E S (Continued)

2 ROBERT LEE

3 WAYNE PRESTONE

4 BILL THUM

5 DON WILSON

6 PANEL 4

7 CFTC MEMBERS:

8 AARON BRODSKY

9 EVE GUTMAN

10 ABIGAIL KNAUFF

11 NANCY MARKOWITZ

12 GEORGE PULLEN

13 RICHARD SHILTS

14 DAVID VAN WAGNER

15 FRANIK FISANICH

16 SCOTT MIXON

17 MICHAEL PENICK

18 PANEL MEMBERS:

19 JIM ALLISON

20 PAUL CAMPBELL

21 LAEL CAMPBELL

22 THOMAS DEAS

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1 A P P E A R A N C E S (Continued)

2 LANCE KOTSCHWAR

3 DAVID FRENK

4 SALLY INGBERG

5 CHARLES REYL

6 LUKE ZUBROD

7

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22 Futures on End-Users

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

2 MR. SHILTS: Good morning, everyone. My name
3 is Rick Shilts. I'm the Director of the Division of
4 Market Oversight here at the CFTC, and with me today is
5 our co-moderator, Ananda Radhakrishnan, the Director
6 of our Division of Clearing and Risk.

7 I'm pleased today to open this public
8 roundtable to provide industry participants and others
9 an opportunity to present their views relating to the
10 listing for trading and the clearing of various swap-
11 like instruments, futures, and options contracts,
12 unregulated designated contract markets, or DCMs. Many
13 have referred to this practice as the futurization of
14 the swaps marketplace, hence the name of the roundtable
15 today. We're looking forward to a very productive
16 discussion.

17 Before we begin those discussions today, I
18 have the pleasure of introducing Chairman Gensler, who
19 has agreed to offer some opening remarks for us today.

20 Chairman Gensler.

21 CHAIRMAN GENSLER: Thank you, and thank you
22 for all attending. Welcome to the Commodity Futures

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1 Trading Commission. I see Commissioner Wetjen. I saw
2 Commissioner O'Malia. I will well imagine that
3 Commissioner Chilton is listening by phone if he's not
4 physically here. I know I saw Commissioner Sommers
5 yesterday. So she may be attending as well, and I
6 thank all of my fellow commissioners.

7 But I mostly want to thank Rick and Ananda
8 and their teams: Scott Mixon, who you'll get to know,
9 who is now our Acting Chief Economist. I want to
10 welcome him also to the CFTC because he has only joined
11 us about a -- is it about six weeks now?

12 MR. MIXON: Two months.

13 CHAIRMAN GENSLER: And I hope you all get to
14 know Scott very well as he helps us guide through this
15 phase of our rule writing and implementation.

16 This is the CFTC's 21st public roundtable
17 since the passage of Dodd-Frank, and next week we'll
18 actually be holding the 22nd, and now that I tell you
19 the topic, it might be as well attended because it's
20 about customer protection. It's actually the third one
21 that we'll have on customer protection.

22 These roundtables have helped us

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1 tremendously. This roundtable is occurring at a
2 historic time in the markets. The marketplace is
3 increasingly shifting to implementation of the common
4 sense rules of the road for this swaps market. I saw
5 Ken Raisler when I walked in. He said it's a very
6 interesting time and evolution in the markets, and I
7 suspect in his practice as well.

8 For the first time, the public will be
9 benefitting from the greater access to the markets and
10 the risk reduction that comes with central clearing.
11 Required clearing of interest rate and credit index
12 swaps begins for financial entities this coming March,
13 March 11th to be more precise. I see Don Wilson is
14 writing down the exact date.

15 For the first time as well the public is
16 benefitting from seeing the price and volume of each
17 swap transaction. This post-trade transparency builds
18 upon what has worked for decades in the futures and
19 securities markets. The new swaps market information
20 is available free of charge on a Website like a modern
21 day ticker tape, and for those of you familiar with it,
22 not that dissimilar from what FINRA has in the

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1 corporate bond market called TRACE.

2 For the first time as well the public will
3 benefit from specific oversight of registered swap
4 dealers. As of the end of this week, there will be 71
5 provisionally registered swap dealers. It has inched
6 up a little bit from the end of December, and we would
7 anticipate that that will continue to do so over the
8 course of this year.

9 They are subject to standards for sales
10 practices, recordkeeping and business conduct to help
11 lower risks to the economy and protect the public from
12 fraud and manipulation. So three first, for the first
13 time central clearing for interest rate and credit
14 index swaps; we have post-trade transparency like a
15 modern day ticket tape; and also the oversight of
16 provisionally registered swap dealers.

17 An early crisis led to similar common sense
18 rules of the road for futures and securities markets,
19 and I believe that these critical reforms in the 1930s
20 have been a foundation of our strong capital markets
21 and many decades of economic growth.

22 In the 1980s, the swaps markets emerged, and

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1 until now it lacked the benefit of such rules to
2 promote transparency, lower risk through central
3 clearing, and promote integrity by overseeing the
4 intermediaries.

5 We know what followed: the 2008 financial
6 crisis, which eight million American jobs were lost. In
7 contrast, the futures markets supported by earlier
8 reforms weathered the financial crisis. President
9 Obama and Congress responded and crafted a swaps
10 provision of

11 Dodd-Frank by borrowing from what had worked
12 best in the futures markets for decades: clearing,
13 transparency, oversight of intermediaries.

14 Given that we have largely completed the
15 swaps market rule writing with 80 percent behind us,
16 today is a good opportunity to hear from market
17 participants on where we are and where we ought to go
18 from here. As we have asked throughout this process,
19 we'd like to hear from market participants today on
20 what provisions for swaps should mirror those for
21 futures, and when is it appropriate for there to be
22 differences.

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1 We've been asking this question, along the
2 way have benefitted from it, but today is a good day to
3 sort of pause and look at where we are and where we
4 ought to go.

5 Congress recognized though that there are
6 some differences between swaps and futures, and I want
7 to mention one that's critical to farmers, ranchers,
8 merchants, and other end users. That is the ability to
9 continue to hedge their risk, lock in a price or a rate
10 in the customized swaps market. Customized swaps
11 sometimes are not standard enough to be cleared, and of
12 course, also end users working through the policy
13 development with Congress even in standardized swaps
14 need to maintain the option and choice as to whether to
15 use that central clearing mechanism.

16 Now that the entire derivatives marketplace,
17 both futures and swaps, have come under comprehensive
18 oversight, I think it's the natural order of things for
19 some realignment to take place. The notional open
20 interest in the futures market, about \$30 trillion
21 notionally open interest. There are various estimates
22 for the notional size of the U.S. swaps market, but

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1 I'll go with the conservative number of about 250
2 trillion notional open interest.

3 So though the futures market trades far more
4 actively in terms of open interest, just one-ninth of
5 the combined open interest of the derivatives
6 marketplace is futures. Think about that.
7 Approximately eight-ninths of the derivatives
8 marketplace, what we had called swaps, and until
9 recently was unregulated; now we bring regulation to
10 both sides. Is it not just natural that there might be
11 some realignment, relabeling now that the whole nine-
12 ninths is under oversight?

13 This roundtable also, I think, provides an
14 opportunity to hear from market participants on recent
15 actions of the two largest exchanges. Bryan, you're
16 not on the end for any reason, but I think everybody is
17 going to be asking -- and where's Tom? Oh, on the end
18 with you -- but the two largest exchanges last fall, as
19 you know, Intercontinental Exchange converted power and
20 natural gas related swaps into futures contracts, and
21 in addition, the CME groups, Clearport Products which
22 were cleared as futures, including those which were

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1 executed bilaterally as swaps, are now being offered
2 for trading on Globex or on the trading floor.

3 I think I got that about right, Bryan and
4 Tom?

5 Okay. CME also adopted new block trading
6 rules for its Clearport energy contracts as well as
7 began trading a futures contract where the underlying
8 product is an interest rate swaps contract. So, again,
9 a good time to have a roundtable.

10 It's important to note that whether one calls
11 a product a standardized swap or a future, both markets
12 now benefit from central clearing, and this feature
13 markets since the late 19th century helps lower risk
14 for the public, but it also fosters access for farmers,
15 ranchers, merchants and other participants and allows
16 them the benefit of greater competition in the markets,
17 and people can come into a clear product and trade on a
18 platform anonymously.

19 In March swap dealers in the largest hedge
20 funds will be required for the first time to clear a
21 certain interest rate in credit index swaps, but when I
22 say "certain interest rate" swaps and credit index

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1 swaps, it's really probably well over half of that
2 marketplace when you measure it in notional values.

3 Compliance will be phased in for other market
4 participants throughout the year. In addition,
5 transparency, longstanding hallmark of the futures
6 market for both pre-trade and post-trade is coming to
7 the swaps market. Now for the first time the swaps
8 market is benefitting from that post-trade
9 transparency. That began on December 31st when the
10 then 66 registered swap dealers began real time
11 reporting for interest rate and credit index swap
12 transactions.

13 Building on this, swap dealers will begin
14 reporting equity, foreign exchange, and other commodity
15 assets at the end of February, and other market
16 participants will begin report April 10th. The time
17 delays are still between 30 minutes long and sometimes
18 up to two days for end user to end user transactions,
19 but generally if it's a swap dealer, it's on a platform
20 that will come down to 15 minutes this October for
21 interest rates and credit index swaps and for the other
22 asset classes the following January. That 15 minute

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1 delay is something very similar to TRACE, if you just
2 want to know its background and where we may have been
3 looking.

4 The futures marketplace has a time delay for
5 blocks for about five minutes. So after we complete
6 the block rule for swaps, trades smaller than a block
7 will be reported as soon as technologically
8 practicable. Those are the words that Congress has in
9 its statute.

10 Oversight of intermediaries and protection of
11 customer funds have also been an integral part of the
12 futures marketplace for decades. Futures commission
13 merchants introducing brokers and commodity pool
14 operators have been registered with the CFTC and with
15 the NFA for a long time.

16 Dodd-Frank extended this oversight to these
17 same intermediaries to include their swaps activity and
18 to promote market integrity, and lower risk to
19 taxpayers also brought oversight to a new class of
20 intermediaries:

21 swap dealers. The initial group of
22 provisionally- registered swap dealers includes the

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1 largest domestic and international financial
2 institutions dealing in swaps with U.S. persons. It
3 includes the 16 institutions commonly referred to as
4 the G16 dealers.

5 So you see there's been a lot of change in
6 the last few weeks. Reforms that CFTC has finalized to
7 enhance protection of customer funds, as well as those
8 proposed and that will be discussed at next week's
9 roundtable, are consistent in that they cover both
10 futures and swaps.

11 Looking ahead to further enhanced liquidity
12 and price competition, the CFTC must finish the pre-
13 trade transparency rules for swap execution facilities,
14 as well as the block rules for swaps.

15 I don't know if you've got the right card
16 there, by the way, Chris, because it says Julian.

17 MR. FERRERI: I'll speak with a British
18 accent.

19 CHAIRMAN GENSLER: What's that? You'll speak
20 with a British accent?

21 But I think that Chris said to me as I was
22 coming in, he said, "Let there be SEFs." I think it's

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1 critical that we complete these rules. The Commission
2 is close to that, and hopefully we can do that in
3 February, but I think it's critical to lower the
4 uncertainty and allow these platforms the opportunity
5 to compete and provide the service to the public that
6 Congress mandated and expected.

7 I think it's also critical that we preserve
8 the pre-trade transparency that has been a core of the
9 futures marketplace, and in that context I'm looking
10 forward to hearing from panelists today about recent
11 actions by the exchanges to lower their minimum block
12 sizes for certain energy futures. As we move forward
13 with transparency in one market, it's natural that some
14 will be relabeled and come over to futures. We
15 wouldn't want to lose what's been a core function of
16 the futures market, both pre-trade and post-trade
17 transparency.

18 I know there's an awful lot to cover. I'm
19 going to apologize in advance because I need to leave
20 here shortly for a Financial Stability Oversight
21 Council meeting, but after that I'll come back and sort
22 of listen. I don't know, Rick, if you're going to

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1 allow Scott, Mark, others to, but I just wanted to say
2 a few thoughts on futures, swaps, and this panel.

3 I don't know. Rick, it's up to you, but I'm
4 sure.

5 MR. SHILTS: Yes, I understand also that
6 Commissioner Chilton would like to make some comments.

7 Bart, are you on the phone?

8 COMMISSIONER CHILTON: Are you reading the
9 five- by-five?

10 MR. SHILTS: Yeah, go ahead. Commissioner?
11 You can go ahead and make your comments now, your
12 opening remarks.

13 CHAIRMAN GENSLER: Bart, can you hear us?

14 (No response.)

15 MR. SHILTS: Yes, we can't hear you. So
16 maybe we'll move on.

17 Commissioner O'Malia also has some opening
18 remarks. Commissioner.

19 COMMISSIONER O'MALIA: Well, thank you, Rick
20 and all the staff for organizing this. I greatly
21 appreciate your assistance, and specifically to the
22 Chairman for allowing this to happen.

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1 I requested this back in November when we
2 were beginning to look at this, and so he has put
3 together and brought the staff together to put a really
4 good set of panels together, and I'm pleased to see
5 everybody here. I know it's a big panel for the first
6 one, and I encourage you to get your thoughts out
7 concisely so we can talk about these issues going
8 forward. Don't wait to be asked. Offer your insights
9 early and often if you will because we just have so
10 many people here today.

11 Some of the issues that I'm really focused on
12 is this margin issue, and I'm glad the clearing houses
13 are here and we can talk about risk because that's what
14 this is about. Margin should be about risk, and we
15 should understand that relationship. So I hope we'll
16 get into that.

17 I'm very interested to hear from the end
18 users. I think the Chairman made his point. What
19 happens if we change the lot rules in the future space
20 to raise those up? They've moved over to the futures.
21 Where will they go? How will they trade? I'd like to
22 hear from the end users on that last panel.

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1 Understanding the relationship on blocks is
2 very important. So I think on the block panel we will
3 capture that. So I'm very pleased with the panels we
4 have and certainly the panelists, a great turnout and a
5 great audience here.

6 There are some more seats up here if you can
7 make your way. It's going to be a long day if you have
8 to stand, so please come forward.

9 And I'd just like to make one other comment.
10 I believe Mr. Wasendorf is being sentenced today. That
11 is great news. The other good piece of good news is in
12 the last month two SROs, CME and NFA, have done a
13 terrific job and have lived up to the commitment they
14 made to the Technology Advisory Committee back in July
15 when we had an emergency technology meeting, is to
16 automate the surveillance of customer accounts, and we
17 are beginning to receive -- we have over 50 percent of
18 the individual customer accounts being screened through
19 an automated, pushed out from the depository banks to
20 be matched up with the FCM data, and within one percent
21 tolerance we're going to be able to see where the money
22 is, and that's critically important to protect

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1 customers going forward.

2 So I think that's an absolutely terrific
3 development over the past month, and I hope that we'll
4 get 100 percent coverage in the very near future to
5 make sure that customers are protected. So there's a
6 lot going on.

7 I also understand MF Global trustees are also
8 coming to some agreement today as well. So it's a big
9 day for this industry, this panel, and the two
10 bankruptcy issues.

11 So I greatly appreciate everybody's
12 participation today, greatly appreciate the staff
13 hosting this event, and I look forward to everyone's
14 comments.

15 Thank you.

16 MR. SHILTS: Thank you, Commissioner, and I
17 think we'll try again and see if Commissioner Chilton
18 is available.

19 COMMISSIONER CHILTON: Yeah, can you hear me,
20 Rick?

21 MR. SHILTS: Yes, we can now. Go ahead.

22 COMMISSIONER CHILTON: Sorry about that. It's

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1 always the difficulty on the blower, you know. I hit
2 the mute button and it disconnects. So I'm sorry, but
3 I did hear everything the Chairman said.

4 I just wanted to make a quick point. You
5 know, we've been hearing a lot about this and not all
6 bad that some of these swaps are becoming futures. I
7 mean, you know, swaps were part of the problem, and so
8 it doesn't bother me that we see some of this
9 futurization, and the question is: does it become
10 excessive? And to deal with that, the best thing we
11 can do is what the Chairman talked about at the end of
12 his remarks, is get on with the SEF rule.

13 I mean, you SEF guys have been ready-go for a
14 long time. It's actually one of the good things that
15 have come out of the delay in the SEF rule, is that you
16 guys are ready to go now, and so we just need to get on
17 with it, and I hope we do so in the next couple of
18 weeks, and I just encourage us to bring it up even if
19 we're not agreed on it all ahead of time. Let's go
20 ahead and bring it up and talk about it and vote on it
21 and amend it if we need to.

22 There is one other concern though that I do

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1 have, and that is with the swapification, the
2 swapification of the futures industry, and I think this
3 is potentially a silent creeper in that, you know, we
4 don't want to take sort of relaxed rules that have been
5 in the swaps space and transfer them to the futures
6 industry, and the futures industry has operated really
7 well. That was the problem with the mess in 2008.

8 So whether or not it's block trades or
9 whether or not it's something else that occurs, either
10 may be occurring or has the potential to occur, in the
11 futures space I want to make sure that regardless of
12 the history of these contracts, whether or not they're
13 swaps, that we don't transfer sort of the regulatory
14 oversight into a less regulated futures industry.

15 So I'm going to have an open mind about all
16 of this. I'm just going to listen after this, Rick. I
17 may just call back in on the listen only line, but I
18 look forward to being enlightened, and thank you for
19 your patience with the telecommunications, and thanks
20 to you all for being here.

21 MR. SHILTS: Okay. Thank you very much,
22 Commissioner Chilton.

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1 As has been mentioned, the actual and
2 potential migration of swaps to the futures markets is
3 evidenced by several recent events both in the energy
4 space as well as interest rate and credit areas. We're
5 very interested in hearing panelists' comments about
6 the potential impact of these events on the derivatives
7 marketplace and the public interest. We're especially
8 interested in learning about the issues and the
9 challenges the Commission should be attending to.

10 We'd also like to know if there are any
11 issues or changes which should be addressed regarding
12 the consistency between the swaps and futures
13 regulations, whether in one of the remaining Dodd-Frank
14 implementing rules that the Commission will be
15 finalizing, or to modifications to the already
16 implemented regulatory provisions.

17 And now before we begin, I'd like to invite
18 my colleague Ananda to give us some opening remarks.

19 MR. RADHAKRISHNAN: Thanks, Rick.

20 And thank you to all of the participants. I
21 think we will benefit tremendously from the thoughts
22 and the discussion. We appreciate you giving your time

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1 to come to the Commission today.

2 And I'm also appreciative of the fact there
3 are so many people here to pay attention to this
4 conference.

5 I want to make a couple points which I hope
6 there will be a discussion about. One is all futures
7 contracts have to be cleared, and as a guy with a
8 slight clearing bias, I think that that is a good
9 thing. The statute provides that all futures contracts
10 have to be cleared by registered DCOs, and there are no
11 exceptions.

12 In the swaps world, the Commission first has
13 to make a determination as to whether certain classes
14 of swaps have to be cleared, and as you heard the
15 Chairman, the Commission has already made the
16 determination with respect to certain interest rate
17 swaps and certain credit default swaps.

18 Number two, even after the Commission makes
19 the determination, not all swaps that can be cleared
20 have to be cleared, and as Commissioner O'Malia alluded
21 to, you have the so-called end user exception.

22 So the question which I'd like discussion on

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1 is:

2 is it a bad thing for all clearable
3 derivatives to become futures?

4 And I'm not demonstrating a bias. I'm just
5 asking: is that a bad thing? Because, you know, if
6 that happens, there will be certainty of clearing
7 because everything has to be cleared.

8

9

10 Does the government have a role to play in
11 this? Should we care about whether all clearable
12 derivatives become futures contracts? And if so, why?
13 And if not, why not?

14 Now, the other issue of course, we've heard
15 Commissioner O'Malia mention that in the swaps arena
16 end users can participate in the swaps market and they
17 don't have to clear and, therefore, there might be
18 lower cost to them; they have opportunities to hedge.

19 So is it essential that there be some swaps
20 that end users can transact without having to clear so
21 that they can take advantage of supposed lower costs.
22 So I hope there will be some discussion on that.

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1 And again, thank you very much and I'll pass
2 it on to Rick.

3 MR. SHILTS: Thanks, Ananda.

4 I need to go through some housekeeping
5 remarks, but first I'd like to, again, thank everyone
6 for coming. It's a really crowded event today, but I'd
7 especially like to thank the staff of the Commission
8 who've put this on, especially our DMO attorneys, Eve
9 Gutman and Abigail Knauff, who largely put this
10 together and made most of the arrangements.

11 For the record, I'd like to note that all the
12 statements and opinions that are expressed today and
13 questions asked by staff are those of the staff alone
14 and do not necessarily represent the views of the
15 Commission or any particular Commissioner.

16 Also, in order to ensure that we're able to
17 hear the opinions of the participants and all of the
18 panelists today, I encourage you to limit your remarks
19 to the time allotted, and please note that the meeting
20 is being recorded. A transcript will be made. The
21 microphones are in front of you. Press the button and
22 you'll see the red light. That means you can speak;

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1 then you should speak directly into the mic, and then
2 when you're done, please press the button and turn it
3 off.

4 We've been asked that you refrain from
5 putting any BlackBerries or other devices on the table
6 as they can cause interference with our system.

7 As you can see, we have coffee, tea, and
8 water in the back, and the restrooms are behind the
9 conference center down the steps in the back.

10 I'd like now to quickly go through the
11 agenda. As you know, we have four panels. The first
12 one is entitled "General Industry Views and Concerns
13 Regarding the Futurization of Swaps in Different Asset
14 Classes." It will run for an hour and 15 minutes, and
15 then we'll take a five-minute break.

16 The second panel is entitled "Clearing and
17 Different Margin Requirements for Swaps and Futures."
18 That will end at noon, and then we'll take a one-hour
19 lunch break.

20 After lunch, we'll start the third panel,
21 entitled "Transaction-Related Matters Including
22 Appropriate Block Rules for Swaps and Futures." That

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1 will go for an hour and 15 minutes.

2 And then our last panel of the day will cover
3 "The Effect of the Conversation of Swaps to Futures on
4 End-Users," and that will end it, and then we'll end
5 the panel discussion today around 3:15 this afternoon.

6 So now I'd like to get started with the first
7 panel, which we'll focus on industry views and
8 concerns. The panelists are invited to identify any
9 issues or challenges that the market participants want
10 to raise related to conversation of swaps to futures in
11 the energy asset class as well as any of the other
12 asset classes.

13 We'd like to you to share your views and
14 whether there are any issues or challenges or changes
15 that we should be considering regarding the consistency
16 between swaps and futures regulations, either in the
17 existing Dodd-Frank rulemakings or by adjusting other
18 regulations.

19 But before we begin the discussion, I'd like
20 to go around the table and have everyone introduce
21 themselves. So I think I can start here. I'm Rick
22 Shilts, the Director of Market Oversight at the CFTC.

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1 MR. RADHAKRISHNAN: Ananda Radhakrishnan,
2 Director of the Division of Clearing and Risk, CFTC.

3 MR. VAN WAGNER: David Van Wagner, Chief
4 Counsel, Division of Market Oversight.

5
6 MR. FISANICH: Frank Fisanich, Chief Counsel
7 of the Division of Swap Dealer and Intermediary
8 Oversight.

9 MR. MIXON: Scott Mixon, Acting Chief
10 Economist.

11 MR. SHILTS: We can finish up here.

12 MS. MARKOWITZ: I'm Nancy Markowitz, Deputy
13 Director of Exchange and Data Repository.

14 MR. BRODSKY: Aaron Brodsky, Exchange and
15 Data Repository.

16 MS. GUTMAN: Eve Gutman, Exchange and Data
17 Repository.

18 MS. KNAUFF: Abigail Knauff, Exchange and
19 Data Repository.

20 MR. SHILTS: Okay. Now let's start, Bryan.

21 MR. DURKIN: Hi. Bryan Durkin, COO, CME
22 Group.

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1 MR. FARLEY: Tom Farley, SVP Financial
2 Markets, Intercontinental Exchange.

3 MR. HARRINGTON: George Harrington, head of
4 Fixed Income Trading, Bloomberg.

5 MR. OLESKY: Lee Olesky, CEO, Tradeweb.

6 MR. MARON: Jeffrey Maron, Managing Director,
7 MarkitSERV.

8 MR. RHODE: Will Rhode, Director of Fixed
9 Income Research at Tabb Group.

10 MR. LEWIS: Cliff Lewis, EVP at State Street
11 Bank.

12 MR. WILSON: Don Wilson, CEO of DRW Trading
13 and also Chairman of FIA PTG.

14 MR. LUKKEN: Walt Lukken, President of FIA.

15 MR. SENFT: Dexter Senft, of Morgan Stanley,
16 representing ISDA.

17 MR. FERRERI: Chris Ferreri, representing the
18 Wholesale Markets Brokers Association.

19 MR. CAMPBELL: Paul Campbell, I lead
20 Deloitte's Energy and Regulatory Risk Practice.

21 MR. PARSONS: John Parsons, MIT Sloan School
22 of Management.

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1 MR. SHILTS: Okay. Thanks to all.

2 And just to quickly review the format, we'd
3 asked each panelist to provide their remarks and to
4 limit them to four minutes or less. Once we hear all
5 of the panelists' prepared remarks, then we'll start an
6 open discussion. So we ask you to please hold your
7 remarks to the four minutes because, as you know, it's
8 a very large panel, so we want to give everybody an
9 opportunity to speak and a chance to ask questions.

10 So with that, let's begin. I think maybe,
11 Bryan, do you want to start?

12 MR. DURKIN: Well, thank you very much.

13 As representative of the CME Group, we
14 appreciate the opportunity to be with this
15 distinguished panel today to talk about the innovation
16 that continues to exist as these markets evolve. The
17 CME Group, we pride ourselves on being a very open
18 institution with respect to the products and services
19 that we offer as a derivatives exchange and also
20 offering our clearing services to the OTC markets.

21 We are very, very much about open access and
22 providing the facilities, products, and capabilities,

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1 deep liquid markets, to manage the risk management
2 needs of the marketplace that comes to our company.

3 At the end of the day, one of the things that
4 we, you know, want to make very clear is, you know,
5 this panel today, the foundation and the principles of
6 the issues have really been premised on longstanding,
7 very well run markets, and those are futures markets.
8 We have had, you know, a long, undisputed history in
9 the context of providing deep, liquid marketplaces in
10 which, you know, we can provide risk management needs
11 from a central common party clearing perspective. We
12 operate markets that clear 11 million contracts a day
13 and have 75 million open interest and we do that with
14 great pride.

15 At the end of the day, as we start talking
16 about some of the issues of topic today in the context
17 of the differences between futures and swaps, there are
18 differences and those differences have been distinctly
19 identified in the context of the rulemaking. And we
20 feel that as markets evolve, you continue to innovate
21 and you provide instruments and services to come along
22 with that evolution.

1 A number of panelists around this table, I
2 think, have over time made some commentary in the
3 context that one size does not appropriately fit all,
4 and I think that that's part of what we're talking
5 about here today, and I wanted to make sure that as we
6 talk about the term, you know, "futuraization of
7 products" we keep in mind that there are very distinct
8 differences between a futures contract which has a
9 tendency to be very standardized and a swap contract
10 which has a tendency to be very customized.

11 There's a difference on risk elements
12 associated with those products, and as such the rules
13 in terms of maintaining and monitoring those products
14 are not necessarily going to be the same, nor should
15 they be.

16 And so we look forward to sharing more of our
17 philosophy on those topics as each of the panelists
18 speak.

19 MR. SHILTS: Tom.

20 MR. FARLEY: Thanks. Thanks for having me
21 here today on behalf of ICE.

22 I'd like to spend my four minutes giving a

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1 little bit of the history of the energy markets. Twelve
2 years ago, the OTC energy markets were opaque. They
3 were phone traded. There was very little, if any,
4 clearing, and during the intervening 12 years in large
5 part because of ICE's efforts, those markets have
6 become transparent. They've become cleared, and the
7 contract terms have largely become standardized.

8 You might have even said that those contracts
9 during that 12-year period have come to look a lot like
10 futures contracts. A slight regulatory breeze may have
11 blow those contracts from swaps land to futures land,
12 and Dodd-Frank as it turns out was little more than a
13 slight breeze. I'll let each of you finish that
14 metaphor privately.

15 So in October, we converted all of our swaps
16 contracts to futures, and it's important to share that
17 our customers loved that decision. In fact, we're a
18 company with dozens of thousands of customers, and of
19 the responses we received, 100 percent, not 95 percent,
20 not 98 percent, 100 percent were supportive of our
21 decision because our customers agreed with us that this
22 was the natural evolution of these markets from purely

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1 OTC to ECM, to SPDC if you're familiar, to fully
2 regulated, fully regulated futures.

3 So what is it that they were choosing on the
4 day we went from swaps to futures? Because it was more
5 than just a naming convention, crossing out the word
6 "swaps" and putting in the name "futures." I've seen
7 it reported in the press. I've even seen it said in
8 Congress that somehow these customers were choosing a
9 lesser regulated market.

10 Here's what they were choosing on the day we
11 converted to futures. Every one of those contracts
12 instantaneously market-wide -- every one of those
13 trades, pardon me, market-wide needs to be reported.
14 Every one of those contracts, as Ananda pointed out,
15 has to be cleared. Every one of those contracts has
16 pre-trade price transparency. Every one of those
17 contracts has a position limit regime.

18 None of those characteristics was true of the
19 swaps market, is true of the swaps market, or will be
20 true of the swaps market under Dodd-Frank.

21 And so I get very passionate about this, as
22 you may be able to tell, and it reminds me that the arc

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1 of ICE's history is about more than ECMs and SPDCs.
2 There's an arc of loopholes. Those of you who have
3 been around a long time can probably guess what I'm
4 referring to, but a decade ago, there was this thing
5 called "ENRON Online." It was conflicted. They were
6 both the owner, but a customer.

7 The customer said, "Hey, ICE, here's an
8 opportunity to build an exchange that's not conflicted,
9 that's more transparent." So we did that, and we were
10 successful because customers really liked it.

11 And then people said, "Well, wait a minute.
12 ICE must have found an ENRON loophole."

13 And so then we as managers, using what we
14 thought was a dose of wisdom at the time, we moved to
15 fully regulated UK futures. Customers loved it. We
16 were successful because our customers really liked it.
17 So, of course, we hear ICE has abated U.S. regulation.
18 There's a London loophole.

19 And so now I'm hoping this is the conclusion
20 of the loophole story because oddly, ironically, we
21 have decided to move our contracts to the gold
22 standard, the global gold standard of regulation, U.S.

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1 futures, the standard bearer, if you will,
2 and I'm here in part to defend a futures loophole,
3 which is beyond affiliated.

4 I just want to conclude with a couple of
5 remarks. I'm a provider of products and services, as
6 are my colleagues, for instance, to my immediate right
7 and left. I'm not a customer. I'm, indeed, self-
8 interested, and my comments should be viewed through
9 that lens, as should many of my colleagues' here on
10 this panel.

11 I urge you to consider what the customers are
12 saying and what's good public policy, and the title of
13 this panel is "General Observations." I'll just leave
14 you with a few.

15 My first general observation, which is the
16 observation of ICE, is what's happening in the energy
17 market is very good for public policy. It has been
18 very good for customers and, quite frankly, is the
19 logical evolution of these markets and was expected by
20 intent market observers.

21 And the second general observation is I just
22 want to repeat that we should seek to differentiate

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1 comments born out of self-interest borne out of self-
2 interest or for commercial one-upmanship, and we should
3 focus on the customer.

4 Thanks.

5 MR. SHILTS: Thanks. George?

6 MR. HARRINGTON: Good morning. Again, my
7 name is George Harrington, and I'm the global head of
8 fixed income trading at Bloomberg based in New York.

9 I want to thank the Commission for giving me
10 this opportunity to present our thoughts and the
11 concerns of our clients on these important issues.

12 Bloomberg is a provider of market data,
13 analytics, trade execution to more than 310,000
14 subscribers globally. Since 2005, Bloomberg has hosted
15 electronic trading in the derivatives market through 24
16 dealers to more than 1,000 end-user customers. In the
17 credit default swap, interest rate swap, commodity, and
18 FX spot markets, Bloomberg is the provider of
19 electronic trading platforms and connectivity to the
20 central clearing houses represented here today.

21 Since 2006, through our broker-dealer
22 Bloomberg Trade Book, we operate a multi-FCM global

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1 futures ISV. Our interest in this debate is to assure
2 that our customers on both the buy-side and sell-side
3 have unfettered access to data and trading services
4 across the broadest range of investment options.

5 Efforts to move segments of the swaps market
6 to futures is not a new idea, and is not a construct
7 from the Dodd-Frank legislation. Over the past decade,
8 there have been multiple attempts by exchanges to
9 launch futures contracts based on swaps, none of which
10 have developed significant liquidity to become viable.

11 The requirement of Dodd-Frank that OTC
12 derivatives be centrally cleared may, in fact, lead to
13 viable swap futures product. However, that should not
14 be a result of disparate minimum liquidation times set
15 forth in CFTC Rule 39.13. When trying to understand
16 the reasoning behind having a one-day minimum
17 liquidation time for futures and options, and a five-
18 day minimum liquidation time for centrally-cleared
19 swaps, we can find no economic argument.

20 The most obvious reason, a difference in the
21 implied risk of the products, is not a factor that we
22 have seen quantified. Of even more concern, there's no

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1 mention of differences in the liquidity of the
2 instruments. There is no question today, as the
3 Chairman just pointed out, there is significantly more
4 liquidity in cleared swap products than in cleared swap
5 futures. In that light the establishment of a margin
6 regime that favors futures over swaps runs the risk of
7 increasing systemic risk.

8 Forced futurization, which the CFTC derives
9 with this rule, risk undermining the central goals of
10 Dodd-Frank. For the topics we're discussing
11 today, the United States Congress had three main
12 objectives:

13 Number one, greater pre-trade price
14 transparency in the market; Number two, reduced
15 systemic risk to central clearing; and Number three,
16 public dissemination of pricing to swap data
17 repositories.

18 To accomplish the first objective, the
19 concept of a swap execution facility was envisioned by
20 Congress. When the swap execution facilities rules are
21 finalized by this Commission, we expect they will
22 require electronic trading of swaps through the display

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1 of executable quotes or request for quote system. This
2 represents a dramatic change in the current form of the
3 OTC market where the great majority of deals are
4 negotiated over the phone on a bilateral basis.

5 Represented in this room today are at least
6 five firms that intend to launch SEFs, assuring a
7 competitive start to the market. A margin regime that
8 dramatically favors futures over swaps lowers the value
9 of the stuff to the point of potentially making it
10 unviable from a business standpoint.

11 The objective of central clearing is nearly
12 universally agreed to be safer for the market. Movement
13 onto the futures market, either natural or forced by
14 the government, will not have an impact on central
15 clearings since both swaps and futures will have the
16 same requirement to clear, but with different margin
17 regimes.

18 To the point I made earlier, a lower margin
19 requirement for a lower liquidity instrument actually
20 increases systemic risk in these clearing houses.

21 The objective of swap data repositories were
22 envisioned as public dissemination tools for all swap

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1 activity. The public good to be served by these
2 utilities was to avoid opaqueness in pricing that was
3 at the heart of the AIG situation in the 2008-2009
4 financial crisis. Forced futurization has a far lower
5 transparency than was envisioned by Congress. The SDR
6 rules call for price dissemination as soon as is
7 technologically possible for swap trades executed via a
8 SEF and after a reasonable delay and after a reasonable
9 delay for block exempt trades.

10 Futures exchange require price disclosure by
11 the day basis. This is obviously a worse outcome.

12 One last point we would like to make is on
13 the risk of moving swap trading offshore by creating an
14 uncompetitive regulatory environment. Global
15 organizations with specific investment needs
16 will continue to utilize the swap market. If the
17 cost of executing these transactions is priced
18 prohibitively high by the Commission, they will likely
19 look around to achieve these financing needs.

20 In summary, we believe the push towards
21 central clearing is very positive for the market, but
22 forced futurization is a negative and can prove

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1 extremely costly to the American consumer.

2 Again, we thank the Commission for the
3 opportunity to be here today and are happy to answer
4 any questions that you have to the best of our ability.

5 Thank you.

6 MR. SHILTS: Okay. Thanks.

7 Lee.

8 MR. OLESKY: Thank you.

9 Tradeweb appreciates the opportunity to be
10 here and participate in today's roundtable. We've been
11 supportive of Dodd-Frank and its policy objectives,
12 pre-trade transparency, market efficiency, and
13 reduction of systemic risk. It has been hallmarks, in
14 fact, of Tradeweb's business since 1998 when we did our
15 first trade in U.S. Treasuries.

16 We're here to provide our perspective and
17 raise our concerns on the issues surrounding the
18 different regulatory regimes for swaps and futures.
19 Fundamentally, we are concerned that as currently
20 constructed and contemplated, the regulatory structure
21 and rulemaking for swap futures creates an uneven
22 playing field for market participants that wish to

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1 trade swaps and allows economically equivalent products
2 to be traded subject to different system rules.

3 The clearest example of this, the difference
4 between the block rules for swaps and futures. That
5 creates two entirely different paradigms in terms of
6 transparency and mode of execution.

7 As currently proposed, the CFTC has set
8 minimum block levels and public reporting times for
9 swaps but not for futures. These differences have more
10 consequences for how these products will be traded and
11 recorded and highlight how the move to futurization may
12 actually lead to less transparency for a very similar
13 risk instrument.

14 In the absence of similar block rules, an
15 economically-equivalent swap and future will be traded
16 entirely differently. The future can continue to be
17 traded bilaterally, off exchange, where the swap it
18 will be required to be traded by an RFQ to a minimum of
19 five as the SEF rules have been proposed.

20 There's really no logical reason for this
21 discrepancy. One is bilateral and one is out to five.
22 In addition, the time in which those trades will be

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1 reported to the public will be different. Swap future
2 will actually be less transparent than its swap
3 equivalent, both pre and post-trade.

4 In short, there should be no difference in
5 the transparency, execution and reporting for the same
6 risk instrument, and we urge the CFTC to address this
7 difference as soon as possible.

8 Further, with more onerous obligations on
9 market participants as it relates to margin, as George
10 just raised, the business conduct rules, cross-border
11 rules, reporting, trading swaps may become less
12 attractive to market participants.

13 Two additional factors are also at play. One
14 is the delay in the SEF rules. Market participants
15 have begun to consider moving away from the swap market
16 really as a result of some of the uncertainty on timing
17 with respect to the SEF rules, in part.

18 Furthermore, the prescriptive nature of the
19 proposed SEF rules will push market participants
20 further away from certain segments of the swap market.

21 In the absence of a level playing field,
22 market participants will not have the flexibility to

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1 choose which products to suit their hedging and risk
2 needs. Instead, they will be choosing one product over
3 the other because of an imbedded regulatory advantage.
4 We do not believe that that's what Congress intended
5 when it passed Dodd-Frank, and we fear that the current
6 construct undermines the goals and policy objectives of
7 Dodd-Frank.

8 Market participants are prepared to trade
9 swaps in a regulated environment with real time
10 reporting, clearing, and mandatory execution, but they
11 need flexibility and choice in how they trade in order
12 to manage their risk and transaction costs, and they
13 want a fair and consistent regulatory regime when it
14 comes to transparency and execution.

15 We believe that if the rules provide for a
16 level playing field, it would foster greater and
17 consistent transparency in the marketplace, and it will
18 also foster competition and innovation among market
19 participants and the various venues that are
20 represented today at this roundtable.

21 We encourage the Commission to consider how
22 their rules concerning swaps and swap futures will

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1 impact market participants' choice of product and the
2 overall impact on the swaps market.

3 Thanks very much.

4 MR. SHILTS: Okay. Thank you.

5 Jeffrey.

6 MR. MARON: MarkitSERV thanks the Commission
7 for this opportunity to participate in the roundtable.
8 More importantly, thanks to the Commission for having
9 the roundtable and listening to the voices and the
10 various views that are available around the table.

11 MarkitSERV is a neutral industry middleware
12 provider offering services and connectivity across the
13 entire community, confirmation services, affirmation
14 services, and other. We connect over 2,500 firms
15 covering over 26,000 different underlying funds. We
16 speak to over 60 different brokers from 20 different
17 clearing houses, and as such, we have a variety of
18 voices from among our customers. What we'd like do
19 today is present the views that we are hearing and the
20 concerns that they raise and some of the
21 recommendations I will put forward.

22 We recognize that market participants trading

1 in derivative instruments may at times find that a swap
2 more appropriately choosing their hedging route
3 investment strategy while at other times the futures
4 contract may be the more appropriate choice. Generally
5 speaking, in the circumstances where an OTC-derivative
6 product has reached a sufficiently high level of
7 standardization and liquidity, there may be a simple
8 basis for creating a standardized futures contract
9 designed to replicate that OTC product.

10 Once futures contracts have been launched for
11 a specific product, they may often be used alongside
12 swaps as an alternative when market participants decide
13 between swaps and futures depending on the uses, users,
14 and product specifications.

15 The recent process of futurization has been
16 marked by a larger scale of migration products commonly
17 traded as swaps to the futures markets. We believe
18 that such overnight futurization, unlike historical
19 market- driven product evolution, has been
20 significantly distorted by regulation. Accordingly, we
21 believe that this market shifts should be carefully
22 monitored by the Commission since it may harm market

1 functioning if market participants are no longer able
2 to find the choice, flexibility, and the liquidity that
3 they require from the swaps markets.

4 This would in particular damage end-user
5 derivatives that require the custom terms that only
6 swaps provide as they look to hedge the risks that
7 arise from their core businesses. Further, such
8 developments might harm competition if the execution of
9 derivatives shifts from a competitive marketplace with
10 many execution venues offering flexible products that
11 can be cleared in any of several different DCOs to one
12 that is dominated from a few standardized products that
13 each trade on a single, vertically-integrated exchange
14 and clearing platform.

15 So just comments and recommendations, we
16 therefore encourage the Commission to carefully monitor
17 future developments, analyze their drivers, and
18 evaluate actions they might need to take to prevent
19 damage to the efficient functioning of the derivatives
20 markets overall. Specifically, we believe that the
21 Commission should mitigate the risks of excessive
22 harmful futurization, regulatory arbitrage by first

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1 finalizing the rules and issuing guidance to ensure
2 that economically-equivalent products are treated
3 equally, regardless of whether they're called futures
4 or swaps.

5 As mentioned, there are issues that differ
6 between reporting rules, margin requirements, tied
7 arrangements between execution and clearing, and
8 block rules. Until we see certainty on all of these,
9 there are differences between them. So recommendations
10 to harmonize the rules applicable to futures and swaps
11 or economically equivalent contracts.

12 Number two, ensuring the regulations
13 applicable to swaps markets are not overly burdensome.
14 Particularly this impacts end users of derivatives. As
15 mentioned by the Chairman and by the Commissioners,
16 it's important that end users continue to have a forum
17 in which they are able to customize transactions to
18 meet their individual needs and hedge. The worst case
19 outcome for all of this would be for them not to hedge
20 their risks and to take those burdens forward without
21 an appropriate forum. SEFs should have the right level
22 of flexibility to executive these contracts.

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1 And, finally, number three, taking sufficient
2 time for the finalization of remaining rules to ensure
3 that swaps markets are not unintentionally
4 disadvantaged. As mentioned by Commissioner O'Malia
5 yesterday, we should make sure we do the rules right,
6 not do them quickly, to paraphrase him, but it's
7 important that we do, do them quickly and do them in an
8 appropriate timetable.

9 What's also important is for the market to
10 have the opportunity to organically come up with its
11 own solutions to various problems that have come up
12 rather than having to force it into a narrow timeframe,
13 such as certainty of clearing.

14 We thank you again for the opportunity to
15 present the information to you today. Much more
16 information is available in the formal comments that we
17 submitted.

18 MR. SHILTS: All right. Thank you very much.
19 William?

20 MR. RHODE: Good morning, members of the
21 Commission and staff. Once again, my name is Will
22 Rhode. I am the Director of Fixed Income Research at

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1 Tabb Group. We're an independent research and advisory
2 firm focused exclusively on the capital markets. I
3 would like to thank the Commission for the opportunity
4 to participate in today's important discussion on this
5 matter of public policy.

6 Swap futures acts as a wrapper to insulate
7 swap users from some of the more punitive elements of
8 Dodd- Frank reform. On the one hand, they may be
9 viewed as a healthy innovative response by the
10 financial services industry to regulatory change. Given
11 that Congress looked to the futures market as a guide
12 for swaps reform, it could be argued that swap futures
13 are consistent with regulatory intent. In many ways,
14 they appear to be a logical progression. On the other
15 hand, swap futures can be viewed as regulatory
16 avoidance. To borrow from Myron Scholes, one of the
17 reasons we have financial innovation is to get around
18 rules and regulations.

19 Swap futures obviate six specific elements of
20 the reform process: dealer registration, margin
21 treatment, block thresholds, clearing competition,
22 execution competition, open reporting. Thus, swap

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1 futures appear to destabilize three pillars of the 2009
2 G20 commitment to reform the swaps market. First, by
3 removing the need for heavy use as swaps to registered
4 dealers and lowering block threshold so that bilateral
5 off-exchange trading may be facilitated, swap futures
6 appear to undermine the G20's transparency goals.
7 Second, the amounts of posted margin for futures is
8 lower than for swaps. This creates concerns that swap
9 futures will lead to more, not less, systemic risk.
10 And, third, the vertical nature of futures clearing and
11 licensing rights appear contrary to the open-choice
12 clearing and execution structure designated by the
13 Commission in the Dodd-Frank rulemaking process.

14 To shed light on the issues and the
15 challenges regarding consistency between swaps and
16 futures regulations, we would like to refer the
17 Commission to a written analysis of three swap future
18 initiatives that we have submitted. In the analysis,
19 we focus on the IntercontinentalExchange's energy swap
20 futures, Eris Exchange's interest rate swap future, and
21 the CME Group's deliverable swap future, but these are
22 by no means the only examples nor will they be the

1 last.

2 Innovation in financial services must be
3 fostered even as the regulatory process unfolds. At
4 some point, rules will need to be finalized in order to
5 allow the seeds of new markets to germinate and grow.
6 The question is whether some level of protection should
7 be afforded to the new horizontal market structure that
8 the Commission has designed so that it may emerge and
9 flourish, or if the Commission will consider swap
10 futures as a viable alternative to the traditional
11 dominance of banks in the OTC swaps market. Both
12 avenues open up the swaps market to new competitive
13 elements which should be considered a success of the
14 Dodd-Frank rule-writing process. The only question
15 that now remains is how best to balance the playing
16 field between these new dynamics so that other tenets
17 of the reform process are just as successfully observed
18 and deployed.

19 The overwhelming message from the market is
20 that swap futures are more efficient, cheaper to use,
21 easier to deploy, and have less regulatory heartache
22 than swaps. They also fulfill many of the major G20

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1 requirements for the treatment of swaps. While we
2 believe swap futures will be successful, we do not
3 believe they will take over the swaps market. That
4 said, we do observe some disharmony in the regulatory
5 treatment of swap futures versus swaps that could
6 advantage the former.

7 Beyond the details, Tabb Group believes there
8 is really only one question the Commission has to
9 consider when it comes to the future of swaps and the
10 role of swap futures. Has the swaps market become
11 overregulated, or is the problem that the futures
12 market is underregulated? We believe the answer to this
13 question will ultimately guide the Commission when
14 considering changes to one of the remaining Dodd-Frank
15 rulemakings or through modifications to already
16 implemented regulatory provisions.

17

18 I would like to thank the Commission for
19 allowing me to present Tabb Group's research and my
20 personal thoughts on swap futures.

21 MR. SHILTS: All right. Thank you.

22 Cliff?

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1 MR. LEWIS: Thanks. I'm going to speak
2 really from the perspective of our clients. State
3 Street is a custodian and an asset manager, the second
4 largest asset manager in the world. I'm going to talk
5 about the pension funds, insurance companies, really
6 financial asset managers when we talk about buy-sides
7 and just answer Ananda's question up front. They would
8 love it if it all went futures; that would be the
9 preferred outcome.

10 And I think I'm going to give an
11 uncharacteristic statement to the Commission: I think
12 the way you've approached this is spot on. I think you
13 ought to hold a parade and declare victory because I
14 think actually moving much of this to the futures
15 market is going to be a huge improvement in buy-side
16 financial market management, not just from a risk
17 perspective but from an efficiency perspective. And
18 I'm saying that despite the fact that I'm spending a
19 lot of money, a lot of the shareholders' money, on
20 creating a SEF. We believe that the market will
21 evolve, that clients will have different requirements,
22 we're spending a lot of money to have a SEF, we're

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1 spending a lot of money to help our clients understand
2 how to use standardized futures products. So we
3 basically -- pardon my expression -- are hedging our
4 bets a little bit in terms of how this evolves.

5 I think intellectually the criticism of the
6 futures model implicit in some of these statements is
7 not borne out by any of the historical record either
8 recent or over the past 100 years. In effect, it comes
9 down to arguing that the clearinghouses are setting
10 margin regimes inappropriately. I don't think that's
11 the case. I think that the standards that the CFTC has
12 created work well. I think, if anything, the
13 clearinghouses have gotten dramatically better, even
14 though, as was noted by the Chairman, they weathered
15 the crisis very well.

16 I think the tradeoffs simply put between the
17 way you treat a CLOB with price reporting requirements
18 that permit transaction cost analysis versus an RFQ is
19 the appropriate distinction.

20 I think the blocks issue is a red herring. I
21 think the issue really from a fiduciary perspective on
22 the buy-side is you have a legal obligation to get the

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1 best price. If you're using blocks to get less than
2 the best price, you're going to go to jail. From a
3 buy-side perspective, it's as simple as that. There
4 are plenty of people who want to make money as
5 whistleblowers in this world, too, so I don't think
6 there is a lot of concern that people are going to
7 drive a truck through that. I think the real issue
8 isn't really expressed. I think the real issue here is
9 the way that dealers make money in the current regime
10 rather than the advantages to the buy- side, which I
11 don't think is a legitimate public policy issue.

12 Let me make one other observation on our
13 experience operating what is in effect a SEF but is in
14 a remaining unregulated environment. I run the largest
15 FX trading platform, electronic platform, in the world,
16 no regulatory compulsion was involved in our customers
17 deciding to do about \$200 billion a day in our various
18 platforms. That's about double the size of FX futures
19 just by way of reference. Well over half of that
20 business is done with RFQ electronically. I remain
21 very confident that many of our customers will choose
22 to use competitive RFQ, as outlined in the SEF rules.

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1 That's one of the reasons we're moving into the SEF
2 arena. So I don't believe everything is going to move
3 futures; otherwise, obviously we wouldn't be investing
4 a lot of money in both preparing for the SEF that we're
5 going to launch as well as preparing to help our
6 customers do more futures trading.

7 I would also point out a fact that is
8 overlooked. There are also advantages to the SEF
9 regime which I think the Commission ought to examine
10 closely, and we've talked to the staff and we're going
11 to continue to talk about this. One very important one
12 is the fact that for the LSOC regime, the fact that the
13 legislation language itself requires for uncleared
14 swaps that buy- side customers have the opportunity to
15 use tri-party custody for margin money. The anomaly,
16 everywhere in the world works that way. All of our
17 overseas buy-side customers use tri-party custody,
18 never had a problem with tri-party custody. We
19 basically believe that futures should be normalized so
20 that futures is not disadvantaged relative to SEF world
21 so the tri-party customer of margin is allowed for
22 futures.

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1 Let me just make two last concluding points.
2 The first point is speaking as somebody who has
3 invested in, as I say, a hedge strategy, SEFs and
4 futures, please focus on getting the SEF rules done.
5 Then we'll have competition decide which work, we'll
6 have some experience to see whether there are problems.
7 We'll take our lumps.

8 We've got some value proposition that we're
9 going to push, basically the fact that we're trying to
10 solve buy-side problems, not preserve existing
11 franchises that have generated tens of billions of
12 dollars in bank revenue on the market-making side.
13 We'll take our chances. We've made the investment.
14 That's the genius of our markets; that's the genius of
15 futures markets innovation. And if there is a concern
16 about that, I just urge that you don't stray from
17 insisting that the rules for SEFs competing among each
18 other, that we keep a level playing field there, that
19 the requirements be the same for the SEFs, and I think
20 that some of the issues need to be -- I don't think you
21 guys should wimp out basically is my point of view.

22 And the last point, if you want to worry

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1 about an unfair advantage, I would worry about -- and
2 this is the 800-pound gorilla in the room -- is the
3 timing of the regulations on the margining of uncleared
4 bespoke swaps. That's the problem in the marketplace,
5 not the difference between futures and SEF. The
6 problem is the timing, and some of the stuff you're
7 reading now is really quite terrifying because that's
8 just going to drive a truck through the whole thing,
9 and even more important I think, Ananda, than the end
10 user exemptions because the end user exemptions really
11 are meaningless so long as the dealers have these new
12 capital requirements because it will simply be
13 unaffordable for market makers to provide liquidity if
14 they're not able to rely upon cleared instruments and
15 the logic of moving to the most liquid transparent
16 fully futurized is going to be pretty compelling.

17 Thank you.

18 MR. SHILTS: All right. Thank you.

19 Don?

20 MR. WILSON: Thank you. I would like to
21 thank the Commission for inviting me to come and talk
22 about this important topic. I am the founder of DRW

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1 Trading Group, which is a proprietary trading firm. I
2 am also the Chairman of FIA PTG, which is an industry
3 group made up of proprietary trading firms; it has
4 about 32 members. I am also, for the sake of full
5 disclosure, the co-inventor of the patent pending
6 methodology, which is the cornerstone of the Eris
7 Interest Rate Swap Futures contract and is also an
8 important element of the recently listed Variance-Swap
9 Futures contract on the CBOE.

10 Futurization has the potential to be one of
11 the most innovative periods in the history of the
12 futures industry. It's a logical, predictable, and
13 healthy reaction not only to Dodd-Frank, but also to
14 Basel III, which incentivizes standardization. The
15 intent of Dodd-Frank was to prevent another AIG.
16 Futurization will certainly help to achieve this goal.

17 It's important in this discussion to
18 differentiate between what happened in the energy
19 markets and what's happening in the fixed income
20 markets. In fact, in the energy markets, I would argue
21 that futurization dates back to the launch of ICE and
22 the creation of ClearPort, which was in 2002. The mid-

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1 October transition was a much less significant step.
2 Perhaps the beginning of futurization and fixed income
3 dates back to the launch of Eurodollar futures
4 approximately 30 years ago.

5 I just want to make a couple of brief
6 comments on this margin debate. I think that a lot of
7 market participants forget that there are actually
8 important differences in the risk to the clearinghouse
9 between identical, economically equivalent cleared
10 swaps and futures. Even for contracts which have very
11 similar liquidity profiles, the swaps market uses LSOC
12 instead of the traditional futures segregation regime.

13 Under LSOC, as I think everybody is aware,
14 the waterfall in the case of a customer loss is
15 different than in the traditional futures regime. In
16 the futures regime, the loss goes to the clearinghouse
17 much faster because the segregated funds at the FCM,
18 where the customer loss took place, are not at risk.

19 My view is that LSOC actually increases
20 systemic risk. It certainly, in any case, increases
21 the risk to the clearinghouse, so it's entirely
22 reasonable and it would actually be shocking to me if

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1 clearinghouses didn't charge higher margins for cleared
2 swaps than for futures as a result.

3 Just a brief comment on block trades. Because
4 identical swaps will trade on competing SEFs, unlike
5 the vertical futures models, it makes sense that block
6 thresholds in swaps should be set universally while
7 DCMs historically have been given the latitude to set
8 their thresholds as they see fit subject to the
9 constraints of Core Principle 9. I don't see a reason
10 to alter that approach.

11 When thinking about the differences in block
12 thresholds across the different regimes, it's important
13 to consider the fact that RFQs on SEFs are essentially
14 private negotiations between a limited number of market
15 participants. In fact, some have advocated one-to-one
16 RFQs, which is simply a block trade by a different
17 name. On DCMs, an RFQ is required to go out to the
18 entire marketplace. That difference in transparency
19 for these types of negotiation processes means that
20 it's entirely reasonable that the block thresholds
21 should be different across these two different venues.

22 Once again, I would like to thank the

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1 Commission for inviting me here. And thank you.

2 MR. SHILTS: All right. Thanks.

3 Walt?

4 MR. LUKKEN: Thanks, Rick.

5 I am here on behalf of the Futures Industry
6 Association. Despite that name, the clearing FCMs that
7 FIA represents actually are agnostic to whether the
8 products that clear are swaps or futures. They
9 certainly have the systems in place or are building the
10 systems in place to accommodate both products. I think
11 the key, as has been mentioned today, to getting this
12 right is to ensure that the regulations being put
13 forward are proportional, they're risk based, and they
14 fit the attributes of each of the different products
15 that we're discussing. If the CFTC can get that right,
16 as the Chairman indicated, there will be a natural
17 leveling over time of some of these products that come
18 into the futures space and vice versa.

19 So in regards to the energy space that's been
20 discussed, I agree with my colleague Don and others
21 that have said that this, despite the revolutionary
22 nature of the rules that they're putting in place in

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1 order to allow swaps to be cleared, the energy products
2 are really an evolutionary occurrence that has happened
3 over the last 12 years, as Don mentioned, with the
4 beginning of 2(h) markets, with the CFMA's passage.

5 Many of you on the ICE, the senior members on
6 the ICE, were around when 2(h) markets began. We
7 started to get some more information over time and we
8 started to layer on futures regulation onto the 2(h)
9 market. So the fact that ICE actually converted these
10 to futures, you know, if I were still around at the
11 Commission back in the day, I would have been popping
12 champagne corks because all the things that happened in
13 the futures markets, the centrally-cleared, the
14 reporting, the large trader reports, all the
15 regulations that go with it over time, to me, that's a
16 healthy thing. And I know today we're talking about
17 the differences between the two markets. I think the
18 key is to make sure that the regulations that are being
19 put on the swap markets are risk based and fit the
20 attributes of those markets.

21 Clearly, one thing I do want to mention, I,
22 before coming on this job, was at a clearinghouse. You

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1 know, the 5-day versus 1-day margin issue is an
2 important one. I do appreciate that the Commission has
3 reserved for itself the ability to adjust the 5-day
4 margin liquidation period for swaps. Having been at a
5 clearinghouse, I know how much testing, how much proof
6 and historical data has to go in to prove the model of
7 whether you can liquidate in 1 day or not. I think in
8 time some of this will adjust on its own in the swap
9 markets, and if truly they are liquid and can show that
10 they can liquidate in a period of time short of 5 days,
11 that it's our hope that the Commission adjusts that
12 accordingly again under this theory that things should
13 be risk based and not just arbitrary in nature.

14 So with that, I'll pass it on to my next
15 colleague, but I appreciate the opportunity for FIA to
16 present today.

17 MR. SHILTS: All right.

18 Dexter?

19 MR. SENFT: Thank you. ISDA appreciates the
20 opportunity to be here today and to comment on this
21 topic. For those of you who might not know, ISDA
22 stands for the International Swaps and Derivatives

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1 Association, and, not surprisingly, we support safe and
2 efficient derivatives markets, be they cleared OTC,
3 non- cleared OTC, or listed futures or options. Of
4 course, the listed products provide us with the widely
5 traded standard benchmarks that we need, whereas the
6 OTC derivatives provide tailored solutions, accurate
7 hedges, and a bed for innovation of new products.

8 The three market segments are complementary,
9 they provide support for one another, and we need all
10 of them. We believe it should be a policy objective to
11 promote efficiency and liquidity in each of these, and,
12 indeed, the sheer quantity of outstanding swaps demands
13 that we have robust markets for trading them. It seems
14 clear to us that congressional intent certainly
15 included the preservation of OTC swap markets. And,
16 finally, we think that any material differences in the
17 treatment of swaps or swap futures should be for
18 logical and objective reasons.

19 Our concern today is that some of the rules
20 do seem arbitrary and seem to create artificial
21 barriers to one derivatives market or another. So what
22 would we suggest the Commission do about this?

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1 Well, we think of rules as falling into three
2 different categories. First you have rules dictated by
3 policy objectives. So those would include business
4 conduct rules, margins, segregation rules, ownership
5 limitations, governance limitations, repository
6 requirements, and so forth. Well, if it's policy, then
7 the rules ought to be reasonably consistent between
8 listed and OTC and, again, differences, to the extent
9 that they exist, should be differences that can be
10 logically explained.

11 Second, there are rules that should be left
12 to commercial competition because they have the
13 objective of spurring innovation and improving
14 liquidity, so these would include eligibility
15 requirements for market makers or other participants,
16 price discovery mechanisms, order books, RFQs,
17 streaming, transaction protocol matters, order priority
18 rules, iceberg orders, workups, and so forth.

19 Lastly, there are rules where policy is
20 behind them, but they have to be informed by market
21 data. So just as we would say that the quantity of
22 margin has to be informed by market liquidity and

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1 volatility, block trade sizes need to consider
2 available liquidity where trade sizes move markets,
3 mandatory execution rules should consider the frequency
4 and regularity of trading.

5 So in closing, let me just say that ISDA
6 believes that market participants should be given a
7 choice, they should be able to choose which derivative
8 products best suit their needs, and that choice needs
9 to be made on a level regulatory playing field, not one
10 that imposes seemingly arbitrary costs or other
11 barriers.

12 Thank you.

13 MR. SHILTS: All right.

14 Chris?

15 MR. FERRERI: Thank you. I'm Chris Ferreri,
16 representing the Wholesale Markets Brokers Association,
17 whose members currently operate global, multilateral,
18 lower case swap execution facilities. We are working
19 very hard to operate the upper case swap execution
20 facilities, but this is a business that we know and
21 this is a business that we do.

22 I would like to briefly discuss the history

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1 that led to the Dodd-Frank Act. Dodd-Frank is the law
2 of the land, and as valuable as all of our opinions
3 are, we have the law as our basis, and I think it is
4 critically important for us to consider that. It does
5 not change what is in place for commoditized futures
6 instruments; however, in setting a framework for swaps,
7 Congress adopted something different than the non-
8 fungible futures model. OTC swaps, with their more
9 episodic liquidity, required a different market
10 structure, the futurization of the swaps market perhaps
11 but not the futurization of swaps.

12 Accordingly, Congress selected and promoted
13 user choice with competitive execution clearing,
14 product fungibility, and trade execution using -- and
15 I'm going to -- the Chairman gave a shout-out to me,
16 I'll shout out to him -- these words are in the
17 statute, "any means of interstate commerce." Congress
18 enacted the laws to ensure that OTC swaps are not owned
19 by one vendor and can be executed on any number of
20 competing systems and platforms including central limit
21 order books, RFQs, price auctions, and multilateral
22 voice systems.

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1 Congressional intent for distinct swaps
2 regulatory regime is thwarted when the name of a
3 product is changed from "swap" to "future" for the sole
4 purpose of moving it from one regulatory framework to
5 another. We should analyze the public policy risks,
6 benefits, and burdens of such regulatory arbitrage and
7 not the commercial interest of any particular company
8 or industry.

9 DCMs were authorized to set their own futures
10 block trade sizes and change them at their own
11 discretion. SEFs must follow CFTC-established block
12 trade sizes. The swaps block trade distinction by law
13 relates to whether a trade is disseminated as soon as
14 technologically practical -- another phrase that's in
15 the law -- on a delayed basis. This distinction has
16 significant impact on liquidity formation. Simply
17 changing a swap to an economically equivalent future
18 can impact how the trade is negotiated, executed, and
19 reported. As proposed, block size will also determine
20 what mode of trade execution can be used by SEFs, such
21 as electronic order book, RFQ, electronic auction, or
22 hybrid voice and screen brokerage, and any other means

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1 of interstate commerce.

2 The CFTC is imposing a futures model -- in
3 this case, DCMs -- on the Dodd-Frank swaps regime that
4 by law is not the futures model. I raise this today
5 because the CFTC is deliberating on final SEF rules and
6 needs to remove this link of block trade size and
7 method of trade execution. Swap block trades should
8 only impact trade dissemination timing and not trade
9 execution method. Not only is the block trade issue
10 important for futurization but for swaps liquidity
11 information as well.

12 Now, briefly on margin. There are important
13 differences in the CFTC's Part 39 rules related to
14 liquidation timeframe for swaps and futures. A recent
15 Risk magazine article projects that swaps subject to a
16 5- day cure period will generate approximately 2.23
17 times the margin held against futures subject to a 1-
18 day period. These rules should be rewritten so that
19 margin is calculated based on actual traded liquidity
20 and other market data and not on whether an instrument
21 is called a swap or a future.

22 Relating a swap product as a future should

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1 not automatically result in more favorable margin
2 treatment on economic characteristics or otherwise
3 identical. It is troubling that futures exchanges are
4 currently touting the lower margin costs for non-
5 fungible swap futures over swaps as part of their
6 printed sales pitch. If swaps are overmargined, then
7 the additional cost borne to the U.S.

8 economy where corporate end users have to pay
9 artificially high clearing costs to hedge a business
10 risk. If futures products are undermargined, then
11 clearinghouses will absorb more risk particularly
12 during a liquidity crunch or a downgrade of its
13 clearing members. Remember, these clearinghouses are
14 designated as systemically important financial market
15 utilities under Title VIII of Dodd-Frank. If
16 inadequate margin causes liquidity crisis,
17 concentration of risk at clearinghouses may require the
18 SIFMA to access the Federal Reserve discount window
19 from the U.S. taxpayer on the hook once again.

20 Finally, urge the CFTC to ensure competition
21 between SEFs and DCMs when finalizing the SEF rules.
22 SEFs must meet impartial access requirements, intention

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1 to permit equal and open participation, and vibrant
2 competition for the benefit of users. In contrast, the
3 futures rules protect dominant market forces by
4 permitting them to further entrench their dominant
5 positions and exclude competitors.

6 If participants prefer futures to swaps, so
7 be it, but it's disingenuous to suggest that swaps and
8 futures are competing on a level playing field with a
9 neutral referee and neutral rules with the outcome
10 driven by product characteristics and user preferences.
11 Even if futurization is inevitable because of a natural
12 migration to order books as swaps become more liquid,
13 it still begs the question why greater liquidity must
14 move to order books operated by a single-silo, non-
15 fungible exchange.

16 WMBA members and other companies operate
17 sophisticated electronic order books ranging from
18 giants like Bloomberg to startup boutiques. With
19 increased liquidity, why can't these products trade on
20 competitive SEFs and exchanges, offering a wide array
21 of trading methodologies? The Commission should ensure
22 a level playing field for more participants whether for

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1 swaps or for futures. If two products act and look
2 alike, they should be subject to similar regulations
3 and similar rules of the road.

4 Thank you again for your time, and I
5 appreciate the opportunity.

6 MR. SHILTS: All right. Thank you.

7 Paul?

8 MR. CAMPBELL: So thank you for the
9 opportunity to be here today. I was at the Commodity
10 Markets Council meeting earlier this week, and
11 Commissioner Wetjen was there as well, and one of the
12 things I heard, I heard frequently, and I would just
13 say the Commissioner heard maybe fervently and
14 patiently is the opportunity for people to come and
15 talk with the Commission and discuss kind of discreet
16 issues and how to solve them.

17 And so for perspective, I lead at Deloitte,
18 our Energy Regulatory and Risk practice, and so the
19 perspectives I am bringing to you today, I am not
20 speaking on behalf of any of my clients, it's the
21 perspective of we're in the business of implementing
22 these rules, and so we're kind of at the last end of

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1 trying to look at a rule, assess what the impact is
2 going to be on a client, and then think about, how do
3 we implement that? And so how do we make choices
4 around business processes, systems that are in place,
5 governance that needs to be either created or amended?
6 And that's the real struggle that we deal with. And so
7 the focus of my remarks are really around, what is the
8 challenge around implementing these rules, and then,
9 frankly, what would be helpful to get from the
10 Commission?

11 And, Ananda, I'll speak to your point they
12 asked in here. And I'm also on the end user panel at
13 the end, and so I'll speak to some other issues I think
14 that are specific to the end user market.

15 I think one thing to think about just in the
16 shift from swaps to futures is really the impact that
17 that's having on the market, and so the perspective I
18 have on this is we're serving a wide range of clients,
19 and this goes from large global entities that trade,
20 frankly, any commodity you can think of across any
21 geography where markets are traded down to very small
22 users that have maybe one swap on their books, and

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1 maybe they have no swaps, and maybe they'll think about
2 putting a deal on next quarter and trying to
3 understand, what are the implications if I do one
4 transaction to hedge one particular risk that I see
5 coming?

6 And so I think in that, it's important when
7 we talk about the market -- and a number of others have
8 focused on this point -- is it's not just a market, a
9 generic market; right? What we're getting to as you
10 start to provide a regulatory framework here is a
11 segmentation of that market, and so understanding what
12 the impact is on those segments of the market. And so
13 if I look at the energy, the resources, market out
14 there, we're starting to see a very clear segmentation,
15 and I think this comes out of some of the shift from
16 swaps to futures, of maybe four different categories,
17 and one is the dealers, those that have registered
18 already or will register, and then those become self-
19 evident. There is another very large category of
20 companies that are, frankly, traders, and we often
21 think of them as kind of between the \$8 billion and
22 long-term the \$3 billion de minimis threshold, we think

1 of those as kind of the "tweeners" because they're not
2 at the status yet of a dealer, so they do not have the
3 requirements to comply with those rules, but they are
4 looking forward 2 or 3 years down the line and
5 understanding that they are going to have to meet
6 those requirements going forward.

7 The third category is companies that are,
8 frankly, trying to do whatever they can to having to
9 avoid the costs required to comply with these rules.

10 And then the fourth is a category of these
11 people that are other, and that actually comprises the
12 largest segment of the market and the segment of the
13 market that is struggling the most with this. So these
14 are not large institutions that have the technology in
15 place to support the implementation, they don't have
16 experience, and so what we're looking to do is provide
17 them guidance on these issues in a standardized and a
18 programmatic way.

19 I think the benefit for many participants was
20 the ability not to hit the \$8 billion de minimis limit,
21 and I think that provided a lot of clarity in terms of
22 where companies were sitting, it allowed them to

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1 frankly not think so much about the qualitative and the
2 quantitative tests, but just to focus on the
3 qualitative test, it's a much easier threshold to work
4 through rather than trying to understand what the
5 qualitative impacts are, of whether you're functioning
6 as a dealer in the market. But that is a large segment
7 that I would say is emerging, and then it's a question
8 as to whether they will migrate towards dealers in the
9 future or they will restrain their trading activity and
10 then move down into just a non-dealer mode or just a
11 standard eligible contract participant.

12 So as I think about challenges we're having,
13 it's guidance that actually targets those different
14 segments and understanding what the implications are
15 for all of those different segments. If you think of
16 the 80-20 rule, most of the market participants
17 actually fall into those lesser categories, they're not
18 dealers, they're frankly not even the large traders,
19 they're the companies that are going to shift
20 completely to futures or are going to maintain some
21 position in the swaps market, and I'll address that
22 specifically at the end.

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1 From a readiness standpoint, our sense is
2 that maybe 25 percent of the market is in any state of
3 readiness here, and that does not mean at a full state
4 of implementation. Nobody is there because the rules
5 have not yet been finalized. But if I think about
6 maturity around being ready, I mean, they've got a
7 program in place, they've engaged counsel, they're
8 actively making changes to business processes and
9 systems or looking for systems that can support this.

10 Other than that, there is a large portion of
11 the market that frankly is really struggling with this.
12 We spend a lot of time advising our clients and
13 providing training to them both formally and informally
14 on this, but I would say there is a gap and frankly a
15 dearth of knowledge coming from the Commission and
16 specific guidance on how to implement this.

17 So the very specific request is, as further
18 guidance comes from the Commission, the more detail we
19 can receive on that, and the more understanding of the
20 different segments that will be receiving that
21 information would be extremely helpful.

22 Ananda, to speak to your question, I think

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1 there is some real risk because there are segments
2 within the energy market that frankly cannot rely upon
3 cleared products because of the nature of their
4 business. They may already be in a process of having
5 an active hedging program, but they're pledging assets
6 against those. That's a very frequent, I would say,
7 hedging strategy and collateral management strategy
8 within the exploration and production business,
9 especially for smaller clients. And similarly, you'll
10 see that with companies that have what I would think of
11 as very strong balance sheets but limited cash flow
12 requirements, and so the ability to post margin on a
13 frequent basis can be a very difficult and damaging
14 thing for them. And I think those are two risks that
15 maybe are unintended. And in the panel this afternoon
16 I'll try to speak about what I see as the unintended
17 consequences coming out of this and the need to look
18 forward and the shift in just frankly commodity prices
19 2 or 3 years out and the implications this will happen.

20 Thank you.

21 MR. SHILTS: All right.

22 John?

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1 MR. PARSONS: Thanks very much for the
2 opportunity to be here and participate in this
3 conversation. I'll try to use my time to crystallize
4 three quick thoughts of mine out of the last few months
5 of conversations on this futurization issue.

6 The first thought I would summarize as
7 they're all just derivatives. Before the financial
8 crisis, before Dodd-Frank, the OTC swaps markets
9 encouraged a myth about themselves that swaps were
10 fundamentally different from futures, that they were
11 special, that they were all about customization, unlike
12 those clunky futures contracts.

13 (Laughter.)

14 MR. PARSONS: And like many other myths,
15 there was a kernel of truth about it. There is a small
16 segment of swaps markets that is about customization,
17 innovation, thinly traded risks, but that just wasn't
18 the whole story. Because the pre-crisis OTC swaps
19 regime provided a space for customization by accepting
20 it from regulation, that also created a loophole for
21 lots of other transactions to move over to the swaps
22 world and these were standardizable or standardized

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1 risks which in the end represented the vast majority of
2 the OTC swaps market.

3 What we're watching right now is the
4 explosion of that myth because as we see a bunch of
5 standardized transactions just suddenly move over to
6 the futures market, we suddenly realize that that
7 didn't define the whole swaps market, so we have to
8 admit that a standardized derivative is just a
9 standardized derivative, you can manufacture it lots of
10 different ways, you can put the label "swap" on it or
11 you can put the label "futures" on it, but from an
12 economic standpoint of trading the risk, there really
13 isn't any difference.

14 The second point I want to make is that the
15 Dodd-Frank Act leveled the playing field. We
16 hear a lot about needing to level the playing field,
17 but if we step back and look at the big picture, that's
18 actually what happened. Pre-crisis, pre-Dodd-Frank,
19 the OTC swap market was not regulated where futures
20 were; the OTC swap market was dark mostly where futures
21 were largely lit; futures were cleared and swaps were
22 not: those three things were the major difference

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1 between the two marketplaces. And now with Dodd-Frank,
2 those three things are gone: swaps are now regulated;
3 most of the swaps market has to become lit; and most
4 swaps have to be cleared. Now that those major
5 differences are gone, erased, trade is naturally
6 rethinking where it goes, and you should expect a
7 significant amount of trade to re-sort itself. What
8 we're focused on now is smaller issues, smaller
9 details, important details, but definitely smaller
10 details than those three big ones.

11 The third point I want to make is that I hope
12 the Commission keeps its eye on the ball. This slogan
13 of creating a level playing field sounds very good, we
14 all want level playing fields, but I don't think it's a
15 very reliable guide for rulemaking actions. In fact, I
16 don't even think it's a very viable long-run strategy
17 for the Commission to pursue in rulemaking. It's not
18 clear to me how feasible it is to constantly and
19 meticulously hunt down any and all regulatory
20 distinctions between swaps and futures regimes.

21 Pause and think for a moment what that really
22 means as you define the future of CFTC rulemaking.

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1 You're going to be constantly constructing two distinct
2 regimes, and while you construct two distinct regimes,
3 you're then going to be going over them to make sure
4 that they're exactly the same, and if that isn't the
5 pure definition of the task of Sisyphus, I don't know
6 what is. If a thoroughly level playing field were the
7 objective, it would just be better to have one regime.

8 An alternative way that I would suggest to
9 approach the rulemaking endeavor is to think about the
10 two marketplaces as serving different needs. I'm not
11 completely sure of exactly what those two different
12 needs should be. Lots of people in the industry know
13 all the different players perhaps better than I do.
14 Maybe the futures market is best for the standardized
15 risk of significant liquidity. Certainly the swaps
16 regime is the only place for customized trades. What
17 you do for other kinds of less liquid and more
18 innovative instruments I'm not sure, but if the CFTC
19 has been tasked with overseeing rules and regulations
20 for two different marketplaces, it seems to me that
21 there has to be some important difference between those
22 two marketplaces, and that difference then naturally

1 plays itself out as you define the rules.

2 The slogan "leveling the playing field"
3 doesn't quite fit the bill, at least not for me. I
4 don't think it's practical, it's ill-suited to the
5 important task at hand because what you want to do is
6 take advantage of having two different marketplaces to
7 provide industry and society of all sorts a more
8 complete array of the types of instruments that will
9 help them to control risks.

10 So let me just conclude, the old pre-crisis
11 regime is over, the Dodd-Frank Act has blown away that
12 major boundary between the two marketplaces. It's
13 reimposed these three key principles on both
14 marketplaces. I think those three key principles
15 should apply to both marketplaces to make the markets
16 safe. There probably remains some other finer
17 distinctions that should define the difference between
18 the two marketplaces, and it would be good to try to
19 focus a little bit on, what are those differences that
20 truly define how one market can serve the needs of
21 business differently than the other market?

22 Thanks for the opportunity to be here.

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1 MR. SHILTS: Thank you very much.

2 And thank you to everyone for your comments.

3 We don't have a whole lot of time. I have one quick
4 question to begin, and since Congress did create two
5 regimes, one for futures and one for swaps, and for
6 those that have identified particular disparities or
7 issues that they think makes for an uneven playing
8 field or whatever, but I just wondered if people had
9 thought about whether you're talking about pre-trade
10 transparency or post-trade transparency or registration
11 issues or margins or whatever, which of those would be
12 statutory and which of those would be regulatory that
13 would be within something that the Commission could
14 actually address? And if anybody has thought about that
15 and could quickly respond. Anyone?

16 MR. FERRERI: This is Chris Ferreri, WMBA. I
17 think the key here is that the statute is very clear
18 that the SEF itself becomes the intermediary, that
19 there is no longer bilateral trading. SEF trading, by
20 definition, is not bilateral, there is a third party
21 involved, and the statute made that very clear. The
22 statute also made it clear that we don't care how that

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1 SEF does a trade, we're going to regulate it. And I
2 think that's the thing that's troubling to the
3 association to the extent that there was no definition
4 of mode of execution in the statute based on the block
5 trade size. Block trade sizes were used to protect the
6 liquidity providers making those markets and providing
7 them with a delay of reporting. So I can crystallize
8 that one point in terms of what I think our concern is.

9 MR. SHILTS: Anyone else?

10 MR. HARRINGTON: In our comments, we clearly
11 are on the margin issue. So we really look at 39.13,
12 which was established by the Commission itself, which
13 point to the difference required in margin between
14 futures and options and swaps, so obviously that seems
15 pretty on point. There were a lot of different
16 comments obviously made here today, but I think the
17 closing comments from Mr. Parsons, you really have
18 equalized the products, and therefore unless there is a
19 liquidity difference -- and there is, except it goes
20 the other way -- it doesn't make sense to have a
21 different margin regime for the two products.

22 MR. LEWIS: Yeah, just to emphasize that I

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1 disagree completely, you've established a minimum in
2 terms of the margining regime, you're out here killing
3 the back. I mean, what you're essentially criticizing
4 the minimum is to say Kim doesn't have to do 1 day for
5 futures that are illiquid, and she won't. These guys
6 have been doing this for -- what? -- since 1921, I
7 guess, when BOTSE (ph) got created, and they've
8 survived world wars, crises, whatever you want to name.
9 Is the 1 versus 5-day as a minimum? Well, again, is 5
10 days the appropriate level? Is it enough? is the more
11 important question.

12 So I think you've gone to the heart of it.
13 Whether you had to do more than that, I think some of
14 the detail may be excessive in terms of how much you've
15 replicated the regulations for DCMs and SEFs, which is
16 just sort of needlessly, I think, adding expense, but
17 trusting the CCPs, look it, if we don't trust the CCPs
18 to set margins the right way, that's a much bigger
19 problem than trying to regulate SEFs. And, again,
20 let's let some competition take place and see what the
21 customers like.

22 MR. SHILTS: And that's going to be the

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1 subject of the next panel. So does anybody have any
2 other comments on my question without focusing on
3 margins and clearing? Because we're going to be
4 talking about that shortly.

5 Yeah, Bryan?

6 MR. DURKIN: Right. I'll leave that to my
7 colleague Kim Taylor, who will have plenty to say, but
8 suffice it to say there are very distinct differences,
9 and to be generalizing the way it's being generalized
10 today I think could be very damaging to the overall
11 marketplace because there are distinctive risk
12 differences, which Kim will outline.

13 There have been some other generalizations
14 made here that I just can't sit here and be quiet with
15 respect to the lack of parity of treatment between
16 swaps and futures as they pertain to the transparency
17 of these products and these markets, and the suggestion
18 that moving any type of similar product or economically
19 equivalently similar product or however it's been
20 categorized today to a less transparent marketplace and
21 trying to tie that to a futures market is just
22 unacceptable to have to listen to that because the

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1 futures markets have many, many decades of development,
2 and these decades of development were premised on
3 transparency and openness. The distribution of our
4 products and our markets are real-time. The
5 information associated with that from a market data
6 perspective, from a clearing perspective, is real-time.

7 There has been suggestion here that moving to
8 the futures market is moving to a block market. Let's
9 be clear: we do provide block facilities and block
10 executions across a variety of our asset classes, but
11 that represents about maybe less than 3 percent of the
12 overall marketplace in the futures market and the
13 exchange trade derivative space.

14 So when I allude to there being 11 million
15 contracts a day that are traded in the futures market,
16 those are done via a central limit order book
17 primarily. The block transactions themselves are there
18 to assist and be responsive to a marketplace to
19 facilitate the execution of larger executions, and
20 again that's being responsive to a marketplace and
21 serving a very strong risk management need.

22 MR. FARLEY: Can I just piggyback on that for

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1 just one moment? It's nice for once to be on the same
2 side of an issue with Bryan.

3 (Laughter.)

4 MR. FARLEY: In some ways, I just want to
5 reiterate what he said, but just put a fine point on
6 it. I've read in two articles over the last several
7 weeks that futures prices are reported on a delayed
8 basis, and it's just one of those myths that just kind
9 of persists, one guy writes it and then somebody else
10 copies it. Just for the benefit of everyone, that's
11 wrong. Futures trades are reported instantaneously.

12 And furthermore, I know in the case of ICE --
13 and we, too, are low single digits for the aggregate
14 number of block transactions not dissimilar from the
15 number Bryan quoted -- in the case of ICE, we actually
16 put our blocks out in many cases in 5 minutes and some
17 other cases in 10 minutes. The last I checked, that's
18 actually quicker than any swap goes out irrespective of
19 whether or not it was a block. So that's all.

20 MR. OLESKY: I think the question is not the
21 current state, I think the question is, what will be
22 the future state? So, really, in response to that, I

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1 wonder when we're talking about swap futures, whether
2 they're credit or rates driven, we expect the same low
3 percentage of those products to be block.

4 MR. SHILTS: Yeah, Bryan.

5 MR. DURKIN: I'm happy to respond to that,
6 Lee. First of all, the swap futures product that was
7 developed was driven by many of our large bank and OTC
8 clients that wanted access to a standardized futures
9 product that would trade in accordance with a central
10 limit order book mechanism, and so again we are
11 providing that very fixed, very standardized product
12 which is not in and of the same as an interest rate
13 swap which has many variable components associated with
14 it, and we do believe that it will cultivate into a
15 very similar phenomena as we experienced with our
16 Treasuries and our Eurodollar complex. Again, that is
17 catering to a specific need of a specific segment of
18 the marketplace. We believe that the two will go hand-
19 in-hand.

20 MR. OLESKY: See, one of the questions or
21 points I was making before is we do see a difference
22 here in a block that occurs through a futures exchange

1 that's essentially a bilateral transaction between two
2 parties and is outside of the order book versus a SEF
3 structure where you have an RFQ that goes out to five
4 different participants.

5 You can make -- and I think the Professor did
6 make -- a fair point that these are different markets,
7 but the fact is we're starting to regulate or will be
8 regulating through SEF the OTC swaps market, and I
9 think you have to have a view as whether or not you're
10 going to embed a regulatory advantage in terms of
11 transparency to one or the other. That is a fact. If
12 it's a bilateral transaction that's a block that does
13 not go through the order book, that is less transparent
14 than an RFQ that's going out to five.

15 MR. SHILTS: Yeah, and we're going to be
16 talking some more about blocks and those types of
17 things this afternoon, but the discussion is
18 interesting. We're a little bit over, but does anyone
19 have more comments?

20 MR. MARON: Yeah, just to your point about
21 what you can do from a regulatory perspective in order
22 to ensure that this was ordered properly. The issue

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1 really is providing choice to those that participate in
2 the markets and allowing them to select whether they
3 want to do futures or swaps, and if one side wins,
4 that's great, and the market will decide, but it's
5 making sure that there is a level landscape that allows
6 that decision to be made and even in a transparent
7 manner.

8 If indeed certain new products are created
9 that are fixed and standardized but are in many ways
10 taking the liquidity away from those that are not fixed
11 and standardized, and it disadvantages those that need
12 that flexibility and they've lost liquidity and the bid
13 offer spread goes wide and the number of market makers,
14 market participants, dissipates, then all of us are
15 hurt by that process.

16 So if you can, on a regulatory basis, make
17 sure that you provide an even level playing field, then
18 I think we're all able to compete evenly.

19 MR. SHILTS: Thank you.

20 MR. RHODE: I would just like to point that
21 the CME and its comment letter on the proposed block
22 rule last year did suggest that perhaps SEFs and DCMs

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1 be allowed to set their own block level. So perhaps
2 that might be the best solution between by taking the
3 CME's view on how SEFs and DCMs should be allowed to
4 set their block levels given their comments on the
5 proposed block rule.

6 MR. LEWIS: One other point which is
7 empirical, which is that in our experience with RFQ and
8 FX, typically market makers make tighter prices in RFQ
9 than they do in a CLOB. So I just make the point that
10 some of this perceived disadvantage of the SEF I think
11 is misplaced. More generally, I think underestimating
12 the importance of continuous pricing as a reference --
13 and I'm not talking to small energy firms -- the point
14 is well taken by the Deloitte's guy -- I'm talking
15 about public asset managers. Look it, they've got
16 nowhere to hide. They've got to trade at the best
17 price or they get a visit to the slam, as I said
18 before.

19 So it is a huge distinction. It's not
20 bilateral; that's a complete misnomer. You have to
21 demonstrate best execution. That has nothing to do
22 with the CFTC, that's got to do with their fiduciary

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1 responsibilities.

2 MR. SHILTS: Well, we've gone a little over.
3 Does anyone else have one last comment before we close
4 this session?

5 (No audible response.)

6 MR. SHILTS: Well, if not, well, thank you
7 very -- oh, I'm sorry. Oh.

8 COMMISSIONER WETJEN: Rick, can I ask a
9 question? Some have alluded to some possible responses,
10 I guess, to the question I'm about to ask, but, you
11 know, the natural order of things as far as the
12 Commission's work here is to finalize the rules that
13 we've already put out for comment, and so we have a
14 collection of trade execution- related rules whose
15 comment periods have ended and we're going to try and
16 finalize soon. We also have our cross- border guidance
17 that was put out for comment; we need to finalize that
18 sometime relatively soon as well.

19 So looking at the context of the immediate
20 tasks in front of the Commission right now that we have
21 rulemakings, what do we need to be thinking about in
22 those rules that address some of the issues that are

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1 raised here? The gentleman from Tabb suggested one
2 idea, although there might be reasons why that might be
3 difficult for us to do, but I would interested in
4 hearing what we should be thinking about doing in these
5 rules that we're about to finalize that might address
6 some of the issues we're talking about. For example,
7 with the SEF rule we have a lot of issues around
8 different trading methodologies of whether or not to
9 permit them or to what degree and so on. And so I
10 would be really interested in hearing some people share
11 their thoughts about that.

12 MR. SHILTS: Yeah, Bryan?

13 MR. DURKIN: Commissioner, thank you so much
14 for bringing that point up.

15 COMMISSIONER WETJEN: Is it okay if I stay
16 seated here for a minute?

17 (Laughter.)

18 COMMISSIONER WETJEN: Okay.

19 MR. DURKIN: It's very important, and some of
20 my colleagues here have said, we need to get clarity on
21 the SEF rules and what the rules for trade execution
22 are going to incorporate. There is definitely a lack

1 of clarity in terms of what the RFQ environment is
2 going to allow for. Is it going to be RFQ for five? Is
3 it going to be RFQ for one? Is it going to be
4 something in between? Those kinds of decisions I think
5 will have an impact and will inform a lot of the
6 discussion that we've been having today in the context
7 of trade execution and thresholds and things of that
8 nature.

9 The marketplace really is just very uncertain
10 in terms of what the outcome and the evolution of those
11 rules that remain pending but unknown to this group,
12 and so whatever we can do to get some clarity there
13 will be very helpful and will inform a lot of this.

14 MR. FERRERI: And just one other comment.
15 These SEFs were envisioned to be competing platforms --
16 right? -- because competition is positive for the end
17 user. That process of having open outcry markets that
18 are similar to pits except there are only SEF operators
19 as opposed to traders in the SEF help to promote the
20 introduction of new prices and better prices. The
21 notion of workup in the wholesale market where a trader
22 is exposed, you know, smaller amounts of a trade, but

1 the entire market is notified it's trading at this
2 price, "Would anybody care to trade at this price?" and
3 to draw on that liquidity.

4 It's also important to know that we talk
5 about the liquidity of swaps. There are some days,
6 quite frankly, when the 10-year interest swap is not
7 very liquid. Right? So the product characteristics
8 may be very liquid as an asset that trades because of
9 the large notional size it can trade in, but there are
10 periods of time when liquidity vanishes. And it's been
11 the 70-, 80-, 90-year history of the wholesale market
12 operators that show there are ways to draw liquidity
13 back into the market.

14 So I think as you're looking at these
15 execution rules, it's keenly important to stay true to
16 the statute, to the "any means" reference, and to
17 really address the fact that these are competing
18 platforms looking to draw liquidity.

19 MR. SHILTS: Yeah, Dexter.

20 MR. SENFT: My answer to your question would
21 be to simply point out that although it's tempting to
22 discuss each of these various rules as if it were an

1 island unto itself, they are not, many of the rules are
2 quite interlinked. I think a large concern of the swap
3 market is the inadvertent transmission of too much
4 information into the marketplace for somebody trying to
5 do a fairly large size trade, that that can be harmful
6 to liquidity.

7 So that information dissemination takes place
8 partly because of trade reporting rules, although those
9 rules are already done and implemented, partly because
10 of the threshold where block rules kick in, and partly
11 in terms of how many people need to see an RFQ. So the
12 Commission does have the ability in writing the rules
13 to consider these interactions. It's only harmful if
14 sort of everything goes the wrong way to the extent
15 that trades are reported immediately and block sizes
16 are very large and lots of people need to see RFQs,
17 then you have a potential problem for the large size
18 trades. So that's really our concern.

19 MR. MARON: The only other thing I would add
20 to that, just to build on that, is when you put the
21 rules forward, making sure that we don't disadvantage
22 one of the mechanisms over another mechanism or under

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1 another mechanism, so that all of the opportunities
2 that were made available for either trading or price
3 reporting are all treated equally and we don't floatate
4 through the embargo rule, say that we've got five
5 different ways of doing it, but if you use the fifth,
6 you're disadvantaged relative to the four, or we do
7 make it available for trading, should we make a
8 mechanism to deem that something as well and provide
9 public comment during that process?

10 MR. WETJEN: Thanks very much.

11 MR. SHILTS: Commissioner O'Malia.

12 COMMISSIONER O'MALIA: I have a
13 question for the panel. I think the -- kind of the
14 academic and the reality of how these markets trade are
15 in somewhat conflict and I'm wondering when we have
16 illiquid products that end up in a futures market, we
17 take the -- we've accommodated the move with energy
18 products with flexible block limits.

19 When we want to apply kind of the academic
20 standard of what futures market should be and getting a
21 certain percentage -- this is related to that Core
22 Principle 9 debate, in this -- while the markets are

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1 trying to find their equilibrium, what should we be
2 thinking about and how tolerant should we be or how
3 flexible should the Commission be in allowing some
4 products to try to futurize and see if they work and if
5 not should we have a process to kick them out, move
6 them back into the swaps market; how disruptive is that
7 behavior? Is it unpredictable if the Commission isn't
8 clear about its rules and where -- what we're going to
9 tolerate? I'm interested to understand -- you know we
10 can draft black and white rules but in reality they're
11 not going to trade in necessarily black and white
12 rules.

13 So what are your thoughts on any of that and
14 how flexible should we be?

15 MR. CAMPBELL: So I'll address that. I guess
16 two points on that. One is, be very tolerant. Because
17 I think when we talk certainly about the energy markets
18 we're not talking about a static market. You know, I
19 think if we think about volatility and the change in
20 prices and what that does to the people that are either
21 burning fuel or producing other products with that,
22 these are incredibly volatile markets that can move

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1 over the course of a day or a weekend given weather
2 shifts in the northeast or the southwest or a hurricane
3 comes through the gulf.

4 And so the ability of those markets to react
5 to what's physically happening to the supply and demand
6 fundamentals I think is critical to understand. So I
7 think one be tolerant but the other is just as
8 important, be clear that you're allowing some period of
9 transition and you're willing to tolerate both that
10 happened. The risk in this comes back to what I think
11 Ananda was asking, the risk is that a market -- and a
12 market is just not as their facility in place to do
13 that but are there willing and knowledgeable
14 participants in that market on both sides? Does that
15 market exist and is it there to support the needs of
16 the end users to actually get transactions done. And
17 the risk is, if everything moves towards a standardized
18 product that there will be a limit of the number of
19 people that are able to facility the quick reaction to
20 I need to hedge a portion of my book or a portion of my
21 production or a portion of my production or my plant
22 portfolio going forward that may not exist or there may

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1 not be enough liquidity in that market to exist.

2 So I think that's a risk of not allowing some
3 transition and recognizing there's a need sometimes for
4 those markets to react very quickly.

5 MR. RHODE: Commissioner, I think clearing is
6 also part of the process of standardization. It allows
7 the product to evolve. What was interesting out of the
8 ICE energy conversion was that it was pretty seamless
9 but that was a product that had been clearing for
10 several years.

11 So that was a process that had allowed
12 standardization which had allowed a conversion to
13 futures. What we're looking at right now of course is
14 products which aren't actively clearing but there is a
15 futures alternative which is standardized and appears
16 to be comparatively, well, rigid within the construct
17 but I think it's the process of clearing and
18 demonstration of clearing and a sufficient level of
19 open interest which introduces the standardization
20 which makes the migration easier.

21 MR. WILSON: The members of the FIA PTG are
22 generally big proponents of encouraging markets to

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1 migrate to central limit order books. Having said
2 that, we recognize the importance of block trades, for
3 trades which would otherwise be disruptive to the
4 central limit order book or for instruments which are
5 perhaps less liquid.

6 The energy markets are very interesting case
7 study and I think that it's obviously important to not
8 do anything that will disrupt those markets. Insisting
9 that if the markets don't, you know, behave in a
10 certain way that they should be delisted or converted
11 to swaps would be incredibly disruptive. Just the fear
12 of that would negatively impact liquidity in a major
13 way.

14 I think that rather than taking approaches
15 like that it's more appropriate to work with the
16 exchanges to make sure that the markets are traded in a
17 way that's consistent with the kind of guiding
18 principles of Core Principle 9 and you know, in the
19 energy markets, for instance, the front months are much
20 more liquid than the back months.

21 And so it's entirely reasonable in my view to
22 have a more nuanced block trade threshold that will

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1 encourage some of the very liquid transparent, easy to
2 price instruments to migrate more to a screen while
3 still permitting the less liquid, more difficult to
4 price instruments to be traded as they currently are
5 using blocks.

6 MR. SHILTS: Any other comments?

7 COMMISSIONER O'MALIA: I have one more
8 question. The issue of liquidity has come up several
9 times in many contexts with both trying to understand
10 what the appropriate margining level is. Jeffrey, I
11 think you brought it up in context to the made
12 available for trade. I'd like to understand you know,
13 when making a made available for trade determination as
14 we develop these rules and consistent with Commissioner
15 Wetjens' question, what do we need to think about in
16 terms of liquidity as it relates to both clearing and
17 made available for trade?

18 MR. MARON: If I could, just to respond to
19 that, in deciding whether to make something available
20 for trade and forcing it onto a screen and onto SEFs
21 and away from the ability for folks to trade those
22 swaps even if they choose to clear them through other

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1 mechanisms, we need to be cognizant of all the
2 different mechanisms that were originally enumerated in
3 the rules that were put forward. So rather than
4 choosing just one of those but to look across all of
5 them and then maintaining that all of those criteria
6 remain true and in force once it moves to a SEF. So
7 that we don't end up in a situation where bid offer
8 spreads widen or the number of market participants and
9 supporters actually make markets in those sectors, step
10 away once they're forced to trade in a certain
11 mechanism rather than in others.

12 So I think it's also important to provide an
13 open comment period for the public to speak to the
14 issues and for the Commission to make the determination
15 rather for individuals to have to make the
16 determination. But also as mentioned for there to be a
17 process to de-MAT or to take something away for trading
18 after a period of time if indeed it doesn't meet the
19 criteria that was originally set out.

20 MR. OLESKY: We've expressed a view on the
21 made available to trade issue. Because we're trading a
22 lot of interest rate swaps and CDS indices today and

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1 there's a tremendous amount of pricing across the curve
2 and in a variety of instruments on platforms like
3 Tradeweb and Bloomberg.

4 So our perspective on that was take a look at
5 what's happening today as an example and possibly you
6 know, fix activity at some agreed upon evidence that
7 there is liquidity today and set that in stone for a
8 period of time and you know, allow yourself to get some
9 experience and some data to support advancing beyond
10 the limits of what the market can support today.

11 So I mean there's a lot of activity that's
12 happening electronically and pricing that's automated.
13 That should be surveyed, assessed, that's a huge
14 percentage of the market today.

15 MR. HARRINGTON: I was just going to comment.
16 I think it's -- that's an area where we would look to
17 the clearinghouses, you know, basically looking at
18 what's going on in cleared open interest, you know, is
19 there enough volume that's already sitting out there.

20 You know there was a question during the
21 discussion yesterday at the Tabb forum regarding self-
22 certification and that's an area where we think really

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1 does not make a lot of sense to have the self-
2 certifying. You know that quickly creates the risk of a
3 race to the bottom. You know, we do believe that the
4 Commission, working with the clearing houses, you know
5 that seems to us to be the right place where an MAT
6 would be made, you know and then the SEFs would
7 basically put the contract on or not.

8 Because at the end of the day, you know, both
9 Lee and I and Chris, you know, we're not providing
10 liquidity, right? We're a source of liquidity, but
11 we're not actually providing it ourselves and therefore
12 the clearinghouse has determined that there is enough
13 open interest or enough activity for the contract to
14 actually clear. The Commission sees that and then
15 basically we would get a notification from you that
16 this would now go on the SEF and we would open the
17 market.

18 MR. LEWIS: Two points, I guess, to both
19 Commissioners' points. Number one, I think the biggest
20 perversion is caused by delay and uncertainty, and I
21 think just finalizing the rules, period, even if
22 they're less than perfect, is more important than the

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1 adjustments that are going to be made between now and
2 then. I think the danger we're running is that we're
3 really -- I think there are a lot of perverse
4 consequences of the current interregnum, if you will,
5 between this regime. Everybody knows the new regime is
6 coming. I think that's the bigger danger.

7 And the other point I'd say, which may be
8 unrealistic given the way the country is run, is I get
9 a picture of Occam, as in Occam's razor, for as you go
10 through this, which is basically the simplest is the
11 best, and I think if you really took a pencil to some
12 of the rulemaking, an awful lot could drop out. I
13 think that the core principles are terrific. I think
14 you just run the risk of unintended consequences as you
15 attempt to improve upon them, and I think basically so
16 long as -- I'll take the point of the professor not to
17 talk about level playing field, but basically keep it
18 simple, very clear and easy to understand what the
19 rules of the road are for everybody that's competing
20 with each other in the SEF space, and let it go and
21 then watch carefully what happens and basically trust
22 the CCPs to basically decide what the margining regime

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1 should be subject to your oversight.

2 MR. SHILTS: Any final comments?

3 (No response.)

4 MR. SHILTS: All right. Well, thank you all
5 very much for your participation on the panel. I think
6 we'll take -- what do you think, five minutes, ten,
7 five? We're going to go take a five-minute break and
8 we'll start back here --

9 MR. RADHAKRISHNAN: Invite the panelists in
10 Panel 2 to come up and take their seats. Thanks.

11 MR. SHILTS: So by 11:40.

12 (A brief recess was taken.)

13 MR. SHILTS: Just quick I want to make one
14 kind of administrative announcement. We appreciate all
15 of the many comments so far, but as an administrative
16 housekeeping matter, we note that because today's
17 presentations have touched on the pending SEF rule, in
18 the roundtable, that that will be placed on the
19 administrative record for that rulemaking.

20 So thank you.

21 MR. RADHAKRISHNAN: So thank you very much.

22 This is the second panel on clearing and margin

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1 requirements for swaps and futures. I think what we're
2 going to do since we're having such a late start, we're
3 going to start lunch at 12:30 and come back at 1:30
4 instead of coming back a 1:00. So Panel 3 will start
5 at
6 1:30.

7 Okay. Let's do introductions first and then
8 I'll go through my short presentation.

9 So again, I'm Ananda Radhakrishnan, Director
10 of Division of Clearing and Risk.

11 MS. WINGATE: Tracey Wingate, Special
12 Counsel, Division of Clearing and Risk.

13 MR. ZUBROD: Luke Zubrod, Chatham Financial.

14 MR. CAWLEY: James Cawley, Javelin Capital
15 Markets.

16 MR. OLSEN: I'm Dave Olsen with JP Morgan,
17 and I'm representing the FIA.

18 MS. TAYLOR: Kim Taylor, CME Clearing.

19 MR. OWENS: Sean Owens, Woodbine Associates.

20 MR. WILSON: Don Wilson of DRW, representing
21 FIA

22 PTG.

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1 MR. BRADY: Neal Brady, Eris Exchange.

2 MR. HATTEM: Jack Hattem, BlackRock.

3 MR. MAGUIRE: Daniel Maguire, LCH Clearnet

4 Group.

5 MR. RADHAKRISHNAN: I'm going to make a short
6 presentation and then I'll invite each of the
7 panelists, similar to the last panel, to make, you
8 know, remarks for what, four minutes and then we can
9 have questions, and so on.

10 What we're going to discuss here is clearing
11 and margin, and I think I've already sort of set the
12 stage for clearing in that there is a distinction
13 between clearing of futures and swaps, and one of the
14 key distinctive issues is that all futures contracts
15 that are traded on a DCM, a designated contract market,
16 must be cleared. This is Core Principle 11 for DCMs.
17 They must be cleared by a CFTC registered derivatives
18 clearing organization or DCO.

19 Contracts that are in swaps, the statutory
20 regime is somewhat different. First of all, it
21 requires the Commission to make a determination that
22 certain classes of swaps have to be cleared, which the

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1 Commission has done in respect of interest rate swaps
2 and CDS, and then secondly, not every participant is
3 required to clear a mandated swap. So even if they
4 engage in a swap that the Commission has determined
5 must be cleared, not every participant has to clear.

6 The example in the statute are the so-called
7 end users. You know, end users are not required to
8 clear. They can if they want to, and as you've seen,
9 you know, the Commission has made certain proposals to
10 exempt other people, other categories of people from
11 the clearing requirement. So those are two
12 distinctions.

13 Now, let's talk about margin. So I've got a
14 short presentation. The relevant regulatory provision
15 is 39.13(g) (2) (ii). So essentially I'm going to skip
16 and go to the heart of the matter.

17 At a minimum, DCO has to use a minimum
18 liquidation time for one day for futures and options.
19 They can go greater than that, but they must do one day
20 for futures and options. A minimum liquidation time
21 for one day for agricultural and energy and metal
22 swaps, and then for all other swaps it's five days.

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1 The Commission did reserve for itself to
2 prescribe a longer liquidation time as appropriate
3 based on specific characteristics or shorter
4 liquidation time, and the Commission can do that either
5 on its own volition or at the petition of anybody who
6 wants to petition the Commission.

7 So that being the case, it's no secret that
8 there have been some comments that the liquidation time
9 period for a particular CME product, the swap futures
10 product, should be five days because it is, quote,
11 unquote, a swap. And my response has been, "Huh, I
12 thought it was a futures contract." And the Commission
13 has spoken about futures contracts, but I guess that's
14 not the end of the debate, and that's why we're having
15 this panel.

16 Hey, Tom, welcome back.

17 MR. FARLEY: Sorry. Thanks.

18 MR. RADHAKRISHNAN: That's okay. So Tom
19 Farley from ICE.

20 So I'd like to start, and instead of starting
21 with the clearinghouses, I'm going to start with the
22 end users. So I'm going to start with end users or

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1 other participants, and I'll have the clearinghouses
2 finish or go to the end. So let's start with Luke,
3 and, Luke, tell me who you're representing.

4 MR. ZUBROD: Sure. Good afternoon, and
5 again, thank you for the opportunity to offer my
6 perspective on futurization of the swaps market.

7 My name is Luke Zubrod, and I'm Director of
8 Risk and Regulatory Advisory Services at Chatham
9 Financial.

10 Chatham is an independent advisor to
11 businesses that use derivatives to manage interest
12 rate, foreign currency, and commodity risks. A global
13 firm based in Pennsylvania, Chatham serves as a trusted
14 advisor to over 1,000 clients ranging from Fortune 100
15 companies to small businesses.

16 Consequently, my views today reflect the
17 perspective of hedgers, and because I will offer the
18 perspective of non-financial hedgers in the fourth
19 panel, I'll focus on financial entity hedgers in this
20 panel.

21 The topic of futurization is an important one
22 for financial entity hedgers. Such entities include

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1 regional banks, real estate funds, leasing companies
2 and others. Like non-financial end users, financial
3 entity hedgers have long valued the over-the-counter
4 derivatives market because of the ability to customize
5 them to perfectly mitigate a company's idiosyncratic
6 risks and because of the ability to bilaterally
7 negotiate margin arrangements with swap dealer
8 counterparties.

9 Regulatory actions that create an incentive
10 for financial entity hedgers to use futures would have
11 at least two adverse consequences:

12 One, basis risk. Regulatory incentives that
13 encourage futures could cause companies to retain risks
14 that they have historically transferred to their swap
15 dealer counterparties, entities that are much better
16 equipped to manage those risks. This basis risk caused
17 by mismatches between a hedge and the risk that hedge
18 is designed to address poses the threat of loss for
19 financial entity hedgers, and it's a loss that could be
20 most severe in times of market stress.

21 Number two, accounting ineffectiveness. Basis
22 risk is reflected in financial statements as accounting

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1 ineffectiveness. Because accounting ineffectiveness
2 and the income statement volatility it creates is
3 difficult or impossible to control, public companies
4 often avoid hedging strategies that might result in
5 ineffectiveness.

6 I'd like to identify an area in which
7 regulators can ensure its proposals do not adversely
8 impact financial entities' ability to reduce risk
9 through hedging: initial margin. While some financial
10 entity hedgers, including regional banks, are
11 accustomed to posting variation margin, few are
12 accustomed to posting initial margin.

13 Initial margin requirements represent an
14 unproductive use of capital for financial entity
15 hedgers, especially those who do not have unencumbered
16 securities which they can post to meet such
17 requirements. Consequently, many financial entity
18 hedgers will seek products that minimize initial
19 margin.

20 Current and proposed differentials between
21 uncleared and cleared swaps and between cleared swaps
22 and futures will create incentives for financial entity

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1 hedgers to use futures, incentives that bring with them
2 the aforementioned adverse consequences of basis risk
3 and accounting ineffectiveness.

4 Harmonizing initial margin requirements
5 between cleared swaps and futures would reduce these
6 adverse consequences. Additionally, eliminating
7 initial margin or allowing for bilaterally negotiated
8 initial margin thresholds on uncleared swaps would
9 further serve to ensure that financial entity hedgers
10 are not encouraged to use products that do not meet
11 their needs and that foist upon them the unnecessary
12 adverse consequences that I mentioned earlier.

13 Thank you.

14 MR. RADHAKRISHNAN: Jamie.

15 MR. CAWLEY: Thanks, Ananda.

16 My name is James Cawley. I'm Chief Executive
17 Officer of Javelin Capital Markets, an all-to-all trade
18 execution venue for interest rate and credit default
19 swaps that expects to register as a swap execution
20 facility or DCM as the rules are finalized. Thanks for
21 inviting me here to participate today.

22 Swaps and futures in swaps are economically

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1 equivalent to each other and should be margined
2 essentially the same way within the clearinghouse.
3 Swaps and their futures' cousins trade in the same
4 currency, are benched off the same index, LIBOR, and
5 are expected to be used interchangeably by market
6 participants for hedging or speculative purposes. To
7 be sure, in certain instances interest rate swap
8 futures accept physical delivery of the underlying swap
9 itself, and in fact, such economic equivalence is
10 confirmed by the fact that to trade such a physical
11 delivery swap, you must open and maintain a swaps
12 clearing account to be prepared to accept its delivery.

13 That swaps and futures in swaps should be
14 measured in the same way is underlined by the fact that
15 the margin calculation can flip from one-day VaR
16 calculation to a five-day VaR, which is the VaR
17 calculation on the underlying swap upon delivery.

18 We argue then that such a future on a swap
19 might be nothing more than a forward swap agreement and
20 thus both should be margined in the same way. There
21 are those who argue that swaps and futures are
22 different because futures represent fewer line items in

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1 the clearinghouse and swaps represent hundreds of even
2 thousands. Thus, swaps could be more difficult to
3 liquidate in a distress scenario.

4 For some this may be a red herring. It's
5 well established that swaps trade in a risk managed,
6 not widget-like, where each swap is individually hedged
7 using exact similar swaps but on a more holistic or
8 portfolio basis where each swap is margined against the
9 curve, where risk and liquidity are viewed on a more
10 continuous and economically equivalent basis.

11 It is expected that market practitioners will
12 risk-manage swap futures exactly the same way,
13 irrespective of line count. Moreover, as history has
14 shown, moving portfolios from seller to buyer in
15 distress scenarios has become more routine over time,
16 whether it be Orange County in the mid-'90s or most
17 recently AIG and Lehman irrespective of line count.

18 And if line count is the issue, should swaps
19 that trade to specific IMM dates that have fixed
20 coupons with up-front cash payments clear on the exact
21 same margins as futures do? Both would, by definition,
22 have the same reduced count of line items in the

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1 clearinghouse.

2 Additionally, there are those who argue that
3 swaps and futures in swaps should clear on different
4 margins because futures are more liquid than swaps. But
5 is this really the case?

6 Consider this. Yesterday the total notional
7 traded of LIBOR-based swap futures was a combined 153
8 million, and in the dollar swap world it was estimated
9 that 200 billion notional traded for the same day.
10 Interest rate swaps are more liquid by that calculation
11 by a ratio of 1,300 to one.

12 For swaps and futures in swaps to have
13 different margin calculations also has considerable
14 policy implications for the economy. If one product,
15 the margin calculation, is much lower than the other,
16 which is correct, what happens to the clearinghouse in
17 the distress scenario if it becomes evident that not
18 enough margin was collected against the lower margin
19 product? Does the taxpayer now enter the breach to
20 cover the shortfall because DCOs have miscalculated and
21 they become systemically important?

22 Or consider the product with the higher

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1 margin collected against it. Could it not be the case
2 that users of such a product are being unfairly
3 penalized as too much margin is collected against their
4 trades? As a consequence, does this not force market
5 participants out towards the cheaper market unfairly?

6 In conclusion, Javelin supports the open and
7 fair development of both markets. In fact, the
8 creation of a new product that adds liquidity to the
9 marketplace should be welcomed, but it should be done
10 in such a way that protects systemic integrity,
11 competition and the end user.

12 The Commission should adopt a more flexible
13 margin approach that more accurately considers the fact
14 that both swaps and futures in swaps are economically
15 equivalent. Their risk characteristics are the same,
16 but may also change over time. Both products should
17 clear on similar margin calculations and, to be sure,
18 liquidity should be a consideration, but it should also
19 be recognized that liquidity will change for both
20 products as the market democratizes and becomes more
21 transparent and competitive.

22 Swaps already liquid will increase in volume

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1 as more dealers compete and new liquidity providers
2 enter the space, along with new execution venues, such
3 as all- to-all limit books.

4 The Commission should immediately pass the
5 SEF rules, and you've heard that a few times now today,
6 but also as an interim step, we suggest that further
7 certification of swap futures be halted until they can
8 be studied for future and full implications.

9 Thank you, and I look forward to your
10 questions.

11 MR. RADHAKRISHNAN: Thanks, Jimmy.

12 Dave.

13 MR. OLSEN: Thanks.

14 I'm Dave Olsen. I run the clearing
15 businesses at JP Morgan, and as I said previously, I'm
16 representing the FIA today.

17 I think first and foremost we're very
18 supportive of the innovation of financial products that
19 allow for end users to safely manage their risks and
20 get the exposures that they'd like to have, and
21 futurization or new futures products are certainly
22 included in that advocacy, and we see that as a great

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1 contribution to the new market structure and endorse it
2 fully.

3 That said, we do think there are some issues
4 with the framework that should be addressed to make
5 sure that it's as safe and effective for the entire
6 market as it can be.

7 I had a friend in college once tell me that
8 he could never live in Europe because he wouldn't like
9 the weather, and for a long time that used to be one of
10 my favorite examples of the pitfalls of generalization,
11 until now where examining the, in my view, arbitrary
12 delineation between a one or two-day cure period for
13 listed futures, a five-day cure period for cleared OTC
14 derivatives, and the proposed ten-day cure period of
15 non- cleared OTC derivatives seems to bundle an
16 incredibly diverse array of financial risks into a
17 shorthand liquidation horizon that we know in practice
18 can't be true.

19 Just in the futures complex, looking at the
20 difference in liquidating S&P E-minis relative to long
21 dated yellow maize or tin contracts, you have very long
22 liquidation tails on some futures and other futures can

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1 be liquidated almost immediately through the central
2 limit order book.

3 The same, too, in OTC derivatives markets
4 today, whether you're looking at two-year interest rate
5 swaps or an aged ten-year high yield index that's
6 rolled down the curve three or four years.

7 So moving to a risk-based and liquidity-based
8 set of principles for the derivation of liquidation
9 horizons we see as an extremely important step in
10 providing both the right framework for innovation as
11 well as safety and soundness for FCMs, DCOs and
12 ultimately the American taxpayer.

13 That said, we do accept that both
14 clearinghouses and FCMs each have a role to play in
15 supply leverage to the system. We don't advocate for
16 true full protection for any loss that could be
17 experienced in having that pre-margined. That would be
18 unnecessary and would be an unnecessary drain on the
19 liquidity in the system.

20 But for like risks and like instruments, we
21 do think comparable margin parameters are important,
22 and part of the innovation that we see or part of the

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1 movement that we see in the market today, although
2 elements are true value added innovation, we believe
3 that some of the moves to futurized contracts are quite
4 overtly driven by an effort to reduce either margin
5 rules or the other elements of regulatory reform.

6 I'll just read the second bullet in the Eris
7 material that they make available on their Website in
8 describing their futures contract. It reads under Eris
9 Exchange Overview, the second bullet being, "No swaps
10 regulatory overhead or swaps reporting."

11 True, but we think that and other marketing
12 material put out by other exchanges and clearinghouses
13 jumps right to the key point of you can create a swap
14 exposure and post future style margin, and that's one
15 of the big reasons for use of the product.

16 The final thing I'd like the Commission to
17 consider is we think a lot about liquidation horizon in
18 one or five or ten. We know that there's a balance. We
19 know that there's a portfolio effect. Some will be
20 more liquid; some will be less liquid, but what's often
21 lost in the discussion is the consideration of when the
22 liquidation can actually begin.

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1 We might all agree that it could take 24 or
2 48 hours or more to liquidate a portfolio, but in the
3 futures market and in most elements of the OTC market
4 today, if one of our customers trades at the open on
5 Monday morning, that position typically is not
6 margined; a margin call doesn't go out until the
7 following morning on Tuesday. That customer then has
8 typically until the end of the Fedwire cutoff at least
9 in the U.S. Tuesday night, and many end users with
10 market power negotiate an additional full day cure
11 period to be able to satisfy a default before
12 liquidation can begin.

13 So you're typically looking at a minimum of a
14 three-day period where you have to endure market
15 volatility before you can even start the process of a
16 liquidation. In the OTC swaps market, five days does
17 cover a log of those administrative elements and
18 documentation elements, but the consideration of either
19 standards on how far in advance cure periods can be
20 given to customers or enforcement by the CCPs
21 themselves seems appropriate.

22 Thank you.

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1 MR. RADHAKRISHNAN: Thanks, Dave.

2 Sean.

3 MR. OWENS: Yes, hi. Good morning. I
4 appreciate the opportunity to be here today and to
5 contribute to today's discussion.

6 My name is Sean Owens. I'm the Director of
7 Fixed Income and OTC Derivatives for Woodbine
8 Associates. We're an independent capital markets
9 consulting firm.

10 And I just wanted to come back and answer
11 your question you posed earlier, you know. Is the
12 migration from swaps to futures, you know, good for the
13 market?

14 And, you know, I think it is, and I think
15 it's what was intended under the Dodd-Frank framework,
16 you know, just provided that we've got the right
17 economic framework and incentives in place at least at
18 the start.

19 And you know, just to recap that, you know,
20 Dodd-Frank through both its capital and margin
21 requirements, you know, makes customized products which
22 are typically riskier, you know, more expensive and

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1 more capital intensive than, you know, standardized
2 products and in futures contracts. You know, non-
3 cleared swaps are, you know, likely going to be subject
4 to, you know, ten-day VaR for initial margin
5 requirements. You know, they've got higher capital,
6 higher risk rate. They've got to incorporate CVA VaR
7 in their counterparty credit charge, you know, versus
8 cleared swaps which are, you know, still customizable
9 products, you know, which are being margined, you know,
10 with five days and given a two percent risk rate versus
11 futures, which are completely generic product, generic
12 risk transfer, you know, one-day VaR.

13 So you know, each product has got margin
14 requirements that reflect its inherent risk and its
15 particular characteristics, you know, be it either a
16 risk profile, liquidity or, you know, degree of
17 standardization.

18 So for this framework to continue to be
19 effective, you know, moving forward, you know, the
20 initial margin requirements for new products need to
21 reflect their characteristics as well, and you know,
22 this is independent of, you know, the underlying

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1 instrument which a swap or a futures contract
2 references, and ultimately whether the label placed on
3 a contract, whether it's, you know, a swap, called a
4 swap or a future, it really comes down to the risk of
5 the product.

6 A couple of good examples are, you know, the
7 Eris flex contracts. You know, they look like a swap.
8 They've got customizable start dates, end dates,
9 coupons. You know, for all intents and purposes, they
10 have similar risk characteristics to a swap and are
11 margined as such.

12 You know, alternatively, the new deliverable
13 swap futures contracts, you know, are standardized.
14 They have many of the features, you know, of a
15 traditional futures contract, very similar to the bond
16 contract itself in a lot of ways. They're not
17 customizable, you know, quarterly IMM settlement dates,
18 you know, set coupon, and should be margined, you know,
19 as such, similarly as normal future with, you know,
20 one-day margining.

21 As far as with regards to the underlying
22 instrument, it's largely irrelevant, you know, whether

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1 it's a bond, a swap, a physical commodity, you know, or
2 even a widget for that matter. What matters is the
3 risk characteristics of the product that's being
4 traded, and that will ultimately determine its, you
5 know, liquidity in the market and its replacement cost
6 in a default situation.

7 So as futurization continues, you know, it's
8 important to ensure that your new products that are
9 being created to transfer risk as participants move
10 from the swaps market into the futures market, you
11 know, seeking capital efficiency, that these products
12 are margined, you know, in accordance with their risk,
13 you know, rather than what they're necessarily called
14 or what they may reference.

15 So thank you.

16 MR. RADHAKRISHNAN: Thanks, Sean.

17 Don.

18 MR. WILSON: Thank you, and thank you for
19 inviting me to serve on more than one panel. This will
20 give me the opportunity to delve into some details and
21 elaborate on some of my comments from the prior panel.

22 To summarize what I said before, futurization

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1 is a good thing, and talking specifically about the
2 margin requirements, you know, I think that one of the
3 things that everybody agrees is that there are
4 important differences between swaps and futures, and
5 therefore, it's entirely reasonable that swaps and
6 futures should have different margin requirements.

7 Although the SEF rules have not been
8 finalized, it's clear that swap trading will be more
9 opaque than futures trading.

10 One of the things that I touched on in my
11 prior comments is that swaps incur greater risk to the
12 clearinghouse than economically equivalent and equally
13 liquid futures contracts. This is because swaps use
14 LSOC instead of the traditional futures segregation
15 regime. Let me elaborate on that a little bit.

16 If a customer who is trading swaps blows up,
17 then the first loss goes to their FCM. If the FCM
18 doesn't have enough money to cover that loss, then the
19 next loss goes into the default fund.

20 In the case of futures, the waterfall is
21 slightly different. The customer blows up. FCM's
22 money is on the line next. Thereafter the loss

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1 actually comes back into the SEG fund's pool at that
2 FCM. After that pool has been exhausted, then the loss
3 goes into the clearinghouse.

4 Now, there are some people who think that
5 that system puts their money at undue risk. As
6 somebody who has very significant amounts of money
7 posted at FCMs, let me tell you that I am actually more
8 comfortable with the futures model than the LSOC model.
9 The reason for that is, well, first of all, we select
10 our FCMs very carefully. We select well capitalized
11 FCMs that have large SEG funds pools. So even in the
12 financial crisis when people were pulling their money
13 out of banks and putting it under mattresses, we felt
14 that our risk of loss from money housed at FCMs was
15 relatively low.

16 You know, the reason for that is that
17 generally our FCMs had over a billion dollars of
18 capital and SEG funds pools of, you know, over \$10
19 billion. So a single customer would have to lose all
20 of their money plus over a billion dollars, and even if
21 they managed to do that, let's say they lost \$2 billion
22 more than they had then and were in a SEG funds pool

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1 with \$10 billion in it. Then we would use ten percent
2 of our money. It's a risk that we could live with.

3 In the LSOC framework, obviously if a
4 customer loses \$2 billion, well, first of all, they may
5 be at an FCM that's not very well capitalized. In LSOC
6 they don't have any incentive; they have very little
7 incentive to choose a well capitalized FCM with a large
8 SEG funds pool. So if they lose \$2 billion and their
9 FCM is thinly capitalized, the clearing default fund is
10 immediately impaired and potentially the whole system
11 is at risk.

12 So in my view, the futures model imposes a
13 lower risk to the overall system than LSOC, and
14 certainly from the perspective of the clearinghouse,
15 it's reasonable that the clearinghouse would demand a
16 higher margin from an LSOC cleared contract than a
17 traditional futures contract. It's only rational.

18 Now, I'm a big proponent of choice and one of
19 the interesting byproducts of this dual segregation
20 regime is that in many cases now the customer can elect
21 to move your dollar futures or Treasury futures over
22 into LSOC, and in doing so they will be required to

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1 post greater margin. Their money will not have the
2 fellow customer risk in the process of doing so. So
3 it's a tradeoff. It's a rational tradeoff. Some
4 people may elect to do that. Personally, I would
5 rather go the other way.

6 So in any case, this differential that a lot
7 of people are very upset about in margins, I don't know
8 of one-day versus five-day is the right difference. I'm
9 not opining on that, but certainly it's logical that
10 there should be a difference, and you know, I think
11 that -- I'm sure that Kim will continue to do a good
12 job of deciding how to set the margin requirements
13 appropriately.

14 Thank you.

15 MR. RADHAKRISHNAN: Thanks, Don.

16 Neal, I'm going to skip you.

17 MR. BRADY: Okay.

18 MR. RADHAKRISHNAN: Because you're the same
19 as the DCO. So I'm going to go to Jack next.

20 MR. HATTEM: Hi, I'd like to thank the
21 Commission first off. I'm Jack Hattem from BlackRock.
22 We're a diversified global asset manager and I'm

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1 responsible for rates derivative investing within our
2 fundamental fixed income group. I'd like to offer a
3 perspective from the buy side.

4 We're a significant user of derivatives and
5 our team spends a lot of time thinking about and
6 working on the challenges in the market as it evolves.
7 The go-live at Dodd-Frank will require portfolio
8 managers, traders and market makers alike to rethink
9 processes.

10 The amount of collateral being posted will be
11 substantially greater than is posted today. The market
12 is going through a period of innovation and new
13 products will emerge. As a fiduciary our objectives
14 include pricing, market depth and counter-party risk.
15 The success of any new product will be driven by
16 liquidity.

17 Futurization of swaps is another evolution of
18 the derivative markets as we move along the path of
19 standardization. We'd expect many aspects of the swaps
20 market to take on more standardized characteristics.
21 Swaps compression or the reduction of line items is an
22 important risk management tool that standardization

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1 aids.

2 Like compression there's a variety of
3 operational efficiencies to be gained from increased
4 standardization. So it's natural to see more swaps
5 futures products trading. The CME's deliverable
6 contract and Eris's cash contractor are two examples.
7 Still challenges remain. These include the consistency
8 of pricing between the futures and the non-futures
9 instruments whose risks they replicate.

10 With any deliverable contract the fluidity of
11 the role remains essential. Additionally with any new
12 instrument there are legal nuances which must be fully
13 vetted before it's widely adopted by the marketplace.
14 For the buy side, this can be a challenge of greater
15 magnitude given the breadth of our business and the
16 sheer number of separate accounts we manage.

17 Of utmost importance remains liquidity both
18 when entering and exiting the trade in addition to the
19 soundness of the framework. Margining is an important
20 element to managing any futures position. Anywhere
21 we're going to find appropriate margin efficiency will
22 help the end user.

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1 The short VaR calculation is appropriate for
2 futures but we must consider the variables driving the
3 VaR determination including liquidity and volatility
4 and what can make them change. The transition to a
5 more standardized market will happen gradually.
6 Watching the rates options market there is no
7 observable gap risk priced into the system.

8 Trading books of several aspects of risks and
9 varied risk profiles will evolve over time. And the
10 market already transacts in fixed coupon IMM swaps,
11 instruments that have standardized features. The
12 increase in these volumes suggest that the market is
13 along the path of transition as traders are thinking
14 about how to efficiently manage their portfolios.

15 Central clearing adds to this fundability.
16 One attractive aspect of a fixed rate IMM swap or a
17 swaps future with common terms is fundability within a
18 portfolio's context. This idea can be extended when
19 thinking of solutions regarding CCP resolution. The
20 market is evolving to decouple execution risk from
21 counter-party risk and we should consider the potential
22 for increased substitutability within the system by

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1 allowing fundability across CCPs.

2 In sum, it's important that all participants
3 within the derivatives ecosystem work together to
4 discuss and address these issues. Our goal as I
5 investors is to seek safe, deep and liquid markets. And
6 for BlackRock, this is where our fiduciary duty to our
7 clients is best served.

8 The connectivity like panels like these
9 provides to all participants is invaluable. Thank you
10 very much for your time.

11 MR. RADHAKRISHNAN: And now I'll go to the
12 infrastructures. Lady always goes first, so Kim.

13 MS. TAYLOR: Thanks, Ananda, thanks for
14 having us today. There's been a lot of discussion in
15 these panels about the intent of Dodd-Frank. And I
16 just briefly want to take it up a notch and talk a
17 little bit about the intent that I think the political
18 leaders globally had with the overall changes in the
19 financial services markets. And I think it had to do
20 with the fact that the crisis showed us that there were
21 non-transparent losses that when -- that had been
22 unrealized and when they became realized, they were --

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1 they caused huge credit issues.

2 The capital reserves were insufficient to
3 weather those market turns and the market was extremely
4 fragile to the collapse of any one counterparty which
5 results in more margin calls which resulted in distress
6 sales. It was a downward spiral and the real problem
7 was that there needed to be a bailout.

8 So I think at a very high level what the
9 political leaders are trying to achieve is an
10 environment that is more resilient to the need for a
11 bailout. And I think that actually you know, Dodd-
12 Frank is the US implementation of those principles and
13 I think that changes in the swap market that help make
14 it more resilient in to credit events are consistent
15 with that objective. And I think enhanced use of
16 futures is also consistent with those objectives.

17 So I think that you know, either one of those
18 works. As far as the market practices associated with
19 risk management, Jamie talked about the fact that he
20 thinks that swaps and futures should be margined
21 effectively the same way and what I would say to that
22 is I agree. And they are. And that is not

1 inconsistent with there being a different coverage
2 period that is applied to one set of products with one
3 set of characteristics and a longer coverage period
4 being applied to another set of products with another
5 set of characteristics.

6 Just real briefly, I want to touch on some of
7 the characteristics that we find important in looking
8 at how we margin different products and maybe at the
9 outset I would like to point out that as we evaluated
10 entering the over-the-counter swaps clearing arena,
11 before there even were regulations that were propagated
12 about any kind of margin coverage period minimum, we
13 had already determined that the margin coverage period
14 we were going to target for the credit default swaps
15 and the interest rate swaps was five days.

16 So it is both a risk management determination
17 on our part and it is a regulatory minimum at this
18 point. So some of the characteristics that go into that
19 decision include the standardization of the product.

20 The futures contract is wholly defined. There
21 are 30 variables on a swap, even the vanilla ones. So
22 there's hundreds of different configurations. You end

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1 up with a lot more line items. That does a couple of
2 things. One is it doesn't allow the liquidity to be
3 concentrated. So it's not as easy for us to take a
4 portfolio and sell it into an open market if the
5 liquidity is not concentrated in a few instruments.

6 If you take a look at the Lehman situation as
7 an example of this, the -- if you had a position in
8 every one of the CME interest rate futures, you would
9 have something like 40 or 50 line items. The intel is
10 that the Lehman option, the Lehman swaps portfolio at
11 LCH was some 60,000 line items. So it's an order of
12 magnitude difference in the ability to concentrate the
13 liquidity.

14 Also the accessibility, the transparency and
15 the continuity of the liquidity is very different now.
16 Might not always be but it's very different now in the
17 way that we would be able to access that liquidity for
18 an interest rate swap versus the way we can access or
19 observe the liquidity for an interest rate future.

20 The Chairman mentioned differences in the
21 open exposure and the daily turnover. I think Jamie
22 focused on the amount of turnover but the relevant from

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1 the clearinghouse's point of view is what does the
2 turnover look like relative to the exposure I'm holding
3 open. And if you look at it that way, interest rate
4 futures turn over I think about 25 times a year and the
5 swaps market turns over about two and a half times a
6 year.

7 So the liquidity that you can access is very
8 different. There's also what I call the diversity of
9 market composition. This is important both in terms of
10 the resiliency of the liquidity in the market. It's
11 not so susceptible to the removal of one or two
12 participants. There are reportedly like five million,
13 estimated five million participants in the futures
14 markets and about 30,000 participants in the swaps
15 market. So there's an order of magnitude difference
16 there as well.

17 The compression or the netting, what I call
18 the positional versus the transactional approach to
19 clearing generally speaking futures net down to very
20 few positions and swaps proliferate more positions.
21 There's more opportunity to net in a cleared
22 environment than there is in a bilateral environment

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1 but it still is not -- it's still going to be an order
2 of magnitude difference.

3 And then the real issue is the default
4 management, the ease of the liquidation. With futures
5 we have a number of choices generally on how we can
6 liquidate. We can go to the open market, we can go to
7 a privately negotiated transaction with one or more
8 counter-parties or we can run an auction and have a set
9 of competitive bidders.

10 And we may do one or the other of those three
11 things depending on the circumstances and the portfolio
12 that we're holding. With swaps, because of the nature
13 of the exposure and because of the size of the
14 portfolio and because of the liquidity profile now, we
15 really only have a single choice which is to run an
16 auction. I think that won't always be true either. But
17 it is true right now that our best way of liquidating
18 is to use an auction and actually the participation in
19 that auction is also somewhat limited by the kind of
20 breadth of the portfolio in a way that futures are not
21 so limited.

22 It's much easier for a wider variety of

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1 participants to participate in an auction for futures.
2 So those are some of the highlights of the reasons why
3 you can effectively be margining those two products the
4 same way and come up with different coverage targets
5 that would be necessary.

6 And then I just want to talk a little bit
7 about the kind of I guess the pyramid of minimums that
8 I guess I would say. Dave talked a little bit about
9 the liquidation horizon and what an FCM faces. So I
10 think it's important for an FCM to be able to charge
11 the margin that it feels it needs and it can.

12 The CFTC's minimum basically imposes a
13 baseline that a clearinghouse can't go below. And then
14 a clearinghouse is going to make a risk assessment on
15 the profile that it faces and charge the clearing
16 members the clearinghouse minimum. And generally
17 speaking the clearinghouse minimum applies as the
18 minimum that clearing members are required to collect
19 from their customers but they're free to assess the
20 risk profile that they face, the portfolio composition
21 that their customers have and the credit-worthiness of
22 their customers and charge additional margin above

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1 that.

2 So there is the freedom for risk management
3 to occur appropriately at all levels.

4 MR. RADHAKRISHNAN: Thanks, Kim.

5 Dan?

6 MR. MAGUIRE: Thank you, Ananda and thank you
7 for inviting us here today. So I represent LCH
8 Clearnet Group based in the US and just a bit of
9 background to the

10 LCH Clearnet Group, established in 1888, a
11 long history in being a clearinghouse, a DCO for
12 futures across a vast array of different products:
13 equity, cash repo and OTC swaps.

14 In terms of who we are and what we do, in
15 terms of swaps, we clear about 60 to 70 percent of the
16 global OTC interest rate swap market. If you believe
17 statistics that's around \$360, \$370 trillion. In the
18 buy side through moves to clear, we now clear 19 out of
19 the 20 trillion that's been cleared year-to-date in 15
20 currencies.

21 And just to make Kim's point, you know, in
22 terms of liquidity and the flow in the market, we clear

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1 on average about \$2 trillion a day. So I think the
2 sort of the throughput is much higher than maybe was
3 alluded to.

4 And on top of that, we've compressed \$170
5 trillion. So there's lot of tools in the interest rate
6 market but we're talking about the future rather than
7 what we do today.

8 So moving on, I think I want to talk about
9 three different things today, transparency, choice but
10 most importantly risk management and regulatory
11 arbitrage seems to be the phrase we're using. So first
12 of all in the transparency, I think it's an interesting
13 two and a half years since I arrived in the States and
14 I was involved in the CFTC round tables and rule-
15 making. I think we should congratulate the CFTC staff.

16 We've seen the OCT market move from what was
17 declared as an opaque and closed access or closed shop
18 market over two and a half years and we're by no means
19 there yet. But over the two and a half years, we've
20 seen it become more open, more transparent. We have
21 now 75 dealers clearing direct. We have indirect
22 clients that are entering and clearing by the FCM

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1 community as well. We have many execution menus joining
2 in the clearinghouse direct as well.

3 So I think open access has definitely been a
4 key part of that. OTC is standardized as well and I
5 think it's learned a lot from its futures partners in
6 that respect. We see much more standardized work flow
7 in the clearing space standardized docks. I should add
8 again, we're not done; got lots to do but I think
9 there's been a standardization around process, which
10 has been welcome.

11 And then disclosure as well. The OTC market
12 was opaque. Now it's doing real-time importing. It's
13 got more clearer customer protection rules. It's got
14 real-time pricing reports in it as well. So some good
15 work has been done there and I think the irony now as
16 you sit here from two and a half years ago when I sat
17 here, OTC was arguing that it was different to futures.
18 Now we're hearing that futures is different to OTC. So
19 I think maybe the two things have come a little bit
20 closer but we're still not there yet.

21 Talking about choice. Cleared OTC means
22 safer OTC maybe. But one of the key things is we

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1 maintain client choice at the execution and product
2 level. Everyone seems to bundle execution and clearing
3 together but they are two separate things. And the
4 vast majority of the OTC customers across the globe are
5 hedging real and non-standard risk exposures.

6 Now, sometimes those are moving to more
7 standardized in terms of the trading pattern but this
8 is really the origin of OTC. The OTC didn't come about
9 to get around a regulatory aspect. It came about to
10 hedge some of the things that my partners on the table
11 have spoken about today.

12 So the idiosyncratic risks from the, you
13 know, main street to market. So forcing the
14 standardized listed products onto a limited number of
15 execution menus is not really providing the clients
16 maximum choice and maximum competition. We believe
17 that you can have a customized product available at
18 multiple execution venues where the clearinghouse and
19 the execution venues are competing but can be cleared
20 in a standardized and most importantly, a well-risk
21 managed way.

22 And I think one of the testaments to that

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1 which is predating the G20 commitment globally,
2 predates the Dodd-Frank that I went to in 2010. It's
3 when we, LCH closed out the Lehman portfolio and Kim
4 was spot-on. Just over 66,000 trades, five currencies,
5 \$9 trillion out to 30 years. But the key point in that
6 is it sounds a lot but we cope with that very well. Had
7 we not maybe swaps clearing wouldn't be a good idea.

8 The reality is, is we used about 20 -- sorry,
9 maybe 30 to 40 percent of the defaulters initial
10 margin, the remainder went back to the defaulters
11 estates and everybody was immunized and no one lost a
12 penny. No one lost a cent.

13 So moving onto the most important part I
14 think is about risk and the potential for regulatory
15 arbitrage to evolve in the market today. I think it
16 was Isaac Newton and his laws of motion said every
17 action has to have an equal and opposite reaction and
18 in my view, having worked in risk management for some
19 time, risk moves, risk morphs but it does not
20 disappear.

21 And that's very analogous to what we're
22 talking about here. If we jam an OTC-cleared executed

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1 -- sorry, an OTC executed, cleared \$400 trillion rate
2 market into a listed and cleared executed \$20 trillion
3 rate market by the exchanges, it's likely to have some
4 stress, some consequence, some intended consequences --
5 sorry, some unintended consequences.

6 So for us, the cleared interest rate swaps
7 and cleared interest rate futures are simply just the
8 product and we seem to be very fixated on the product.
9 The real underlying market is the interest rate market.
10 Not swaps, not futures, quite frankly, not bonds
11 either. And re-characterizing risk from swaps to
12 futures in our view is really missing the point.

13 In futurization, the market risk will remain.
14 It's merely just transferred from one product to
15 another. So at the end of the day, the vehicle that you
16 drive to get rates exposure, interest rates exposure is
17 very simply a product. Futures, swaps, bonds, options
18 or any other innovative product that comes out over
19 time, the key concern for a clearinghouse from a risk
20 management and closeout standpoint and from a systemic
21 and regulatory risk perspective is as simple as
22 follows.

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1 You need to know the vehicle that you're
2 going to drive to get out of a problem. That's the
3 default. Secondly, you need to understand, will the
4 vehicle be there when you have that event? And can you
5 actually get your hands on that vehicle? That's
6 liquidity or scarcity of product.

7 And finally, once you've got the product,
8 will you have enough gas, financial resources, margin,
9 default fund and the like to actually drive your way to
10 safety? Because that's the most important point for
11 systemic risk reduction.

12 So to try and wrap up, we think it's simply
13 artificial and potentially a regulatory quirk that a 10
14 million DV01 risk position enlisted LAN would attract
15 one or two-day margin. Whereas a similar 10 million in
16 DV01 risk in OTC land would attract five days or more.
17 The key in all of this from a risk management
18 standpoint is about liquidity and having access to it
19 in the prevailing and underlying market.

20 And it's really for the practitioners to
21 determine what the best holding period is around that.
22 I agree with David's comments; risk-based and

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1 liquidity- based holding periods are the key to all of
2 this and maybe we should look as an industry in
3 conjunction with the regulators at both future swaps
4 and other product holding periods rather than just
5 having a one-size-fits- all for all of these.
6 Otherwise, we could end up with some form of
7 concentration risk or liquidity risk or in fact
8 closeout risk at the CCP. Thank you.

9 MR. RADHAKRISHNAN: Thanks, Dan. Neal?

10 MR. BRADY: Thanks, Ananda, and to the
11 Commission for the invitation to speak here today at
12 the roundtable. My name is Neal Brady. I am CEO of
13 Eris Exchange, a DCM offering interest rate swap
14 futures contracts.

15 Eris Exchange is futurized interest rate
16 swaps by offering an innovative futures contract that
17 embeds the cash flows of an OTC swap. CME Clearing,
18 you know, Kim and her very professional team, clearly
19 contract and set the margin levels. Eris contracts
20 trade and clears cash-level futures from inception to
21 termination, meaning they are subject to futures
22 regulatory regime from start to finish and do not

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1 physically deliver into swaps.

2 Eris Exchange was formed in the first half of
3 2010, prior to the passage of the act itself, much less
4 any of the subsequent CFTC rules we're discussing
5 today. At Eris, we foresaw the imposition of regulatory
6 and capital requirements on previously under-regulated
7 OTC swaps would be the tipping point that would push
8 the most liquid swaps to migrate to futures. The
9 migration from OTC to futures is part of a well-
10 recognized life cycle of derivatives products, and we
11 shouldn't be surprised to see this phenomenon playing
12 out for certain liquid swaps.

13 Despite being futures, Eris products did not
14 have one-day VaR margins. CME Clearing requires five-
15 day VaR margins for Eris flex contracts, as was
16 mentioned in one of the earlier comments. These flex
17 contracts mirror the date and rate flexibility of
18 trading interest rate swaps. For Eris standards, which
19 are, as the name implies, more standardized and
20 futurized in their construction, CME Clearing currently
21 requires two-day VaR margin.

22 We believe that the Commission's finalized

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1 DCO rules properly recognizes distinct structural
2 frameworks of swaps and futures in setting initial
3 margins, even for products based on common indices.
4 Futures markets are supported by a larger, more diverse
5 set of participants, have more firms qualified to
6 participate in default auctions, and are often backed
7 by larger clearing guarantee funds and our cleared
8 swaps. Interest rates futures have traded for many
9 years and fully transparent, all-to-all central limit
10 order books while the Dodd-Frank rules for electing
11 trade of cleared swaps have yet to be finalized and
12 will permit swaps to be traded in more opaque RFQ
13 mechanisms.

14 At this point, I just want to respond to
15 Dave's comment earlier because the Eris marketing
16 material was mentioned. We do very clearly state that
17 we're not subject to swap price reporting, swap
18 regulatory regime. We're unabashed in saying we follow
19 the futures guidelines in the well-known regulatory
20 framework. And specifically on pricing, we have a --
21 and we'll get to this in the session after lunch, but
22 we have a mandatory central limit order book with

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1 anonymous streaming prices. Our RFQs, our all-to-all
2 prices are reported real time. In fact, our prices are
3 reported on our website, the same place where our
4 marketing brochure talks about not being subject to
5 swap pricing regimes. They are two distinct regulatory
6 regimes. That's a very key point that was mentioned by
7 Professor Parsons earlier. I think that sort of
8 underpins a lot of our position on both the margin and
9 the block trade issue.

10 On the clearing side, futures markets have
11 for years offered real-time clearing intraday
12 collection of variation margin, automated give-up
13 capabilities. For clearing at Eris, these practices
14 are either new or in some cases not implemented.
15 Perhaps most importantly, the CFTC's guidelines
16 prudently recognize that the swap clearing framework
17 has yet to be fully tested. To my knowledge, the DCO
18 has not yet handled the default involving new cleared
19 swaps, nor has the new 4d(f) account class been tested
20 by a major bankruptcy.

21 A recent article in Risk magazine highlighted
22 one possible issue that could complicate swap defaults

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1 related to treatment of pension fund assets under
2 ERISA, which was clarified for futures by the
3 Department of Labor more than 20 years ago. This
4 particular issue affecting cleared swap margin was
5 recognized in advance and seems to be on track for
6 resolution before causing any real damage, but until we
7 observe multiple successful defaults involving cleared
8 swaps and gain confidence that all similar operational
9 legal risks have been unearthed, it seems prudent to
10 err on the side of caution in setting margin levels.

11 DCOs are the foremost authorities on
12 appropriate margin levels. And their actions
13 demonstrate similar prudence. The final DCO rules,
14 Ananda, you mentioned in the opening here stipulate
15 minimum five-day margins for IRS and permit DCOs to
16 petition the CFTC for reductions. Since then, no DCO
17 has submitted to the Commission a request to lower IRS
18 margins. And, to our knowledge, no DCO has stated
19 publicly that they would set margins lower if the CFTC
20 mandate were relaxed. LCH continues at our IRS margins
21 for customers at a seven-day VaR level in excess of the
22 CFTC minimum.

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1 In short, the industry's and regulators'
2 conservative approach to setting margin levels for new
3 and untested cleared swaps is warranted. And the
4 market evolution of certain liquid swaps to efficient,
5 highly regulated, and well-tested futures markets
6 should be expected and welcomed.

7 Thanks.

8 MR. RADHAKRISHNAN: Thanks, Neal. Tom?

9 MR. FARLEY: Thanks, Ananda. And thanks
10 again for allowing ICE to be a part of Panel 2.

11 I was struck by the clarity and completeness
12 of Tim's comments, and I was also struck by the fact --
13 the degree to which many of our comments overlapped
14 with my own. So I am going to kind of recraft and ad
15 lib a little bit so as to shorten my comments, not drag
16 everybody through some of the same arguments, which Kim
17 said better than I would.

18 ICE operates five clearinghouses. We operate
19 them on both sides of the Atlantic. And we operate two
20 leading OTC clearinghouses and two leading futures
21 clearinghouses. The reason why I go through that kind
22 of quasi brochure is to tell you that we are pretty

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1 well- positioned to talk about this margin issue,
2 specifically with respect to swaps v. futures.

3 Our risk managers and the heads of our
4 clearinghouses, they ask the questions for any given
5 portfolio, how long will it take me to liquidate this
6 thing, and how much might it cost me? There's been a
7 lot of conversation today, which I wholeheartedly agree
8 with, that fundamentally the most important thing with
9 each particular product is, what is the liquidity of
10 that product? And that's the analysis we do.

11 And I won't get into the definition of
12 liquidity, although we could discuss that if there is a
13 follow-up question. But there are two other points,
14 and Kim touched on them to some extent but I want to
15 reiterate. One is, how operationally complex is that
16 liquidation? And let me pick an extreme example for
17 effect because I think it will help with the example.

18 In the futures model, in many cases, you have
19 a DCM and a DCO which are affiliated and they are under
20 common control. Operationally, quite frankly, that is
21 pretty easy when it comes to liquidating a portfolio. I
22 personally have been part of it, unfortunately,

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1 multiple times. And I have seen in that scenario it's
2 quite simple.

3 Conversely, if you imagine a scenario where
4 perhaps, again, exaggerating for effect, there are 20
5 SEFs as well as trades that are maybe being blocked in
6 and there is one DCO, there is operational complexity
7 of a whole different sort. And I think reasonable
8 people can agree on that.

9 And, then, finally -- and, again, I won't go
10 through the whole thing because Don said this in a very
11 articulate way -- there are fundamental differences
12 with the customer segregation regime. So when our risk
13 managers start saying, "Well, how much might this cost
14 me?" that is related to the question of "What is in my
15 waterfall?" And, with respect to OTC, there's less in
16 the waterfall. There just is. That is fact-based.

17 So as we step back and we think about what is
18 the role of government here -- and I won't get into the
19 role of government; we could have another whole-day
20 panel to discuss that -- I am stipulating that the role
21 of government here, the role of the CFTC, is to set
22 some reasonable minimum standards because we don't want

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1 people competing on risk.

2 And I heard in the first panel the comment
3 that one-day v. five-day is arbitrary. I agree. It's
4 arbitrary. It's also arbitrary that New York Avenue's
5 35 miles an hour and then you get to the Washington
6 Times Building and it goes to 45. That's reasonable.
7 Sixteen years old is the age to get a driver's license.
8 It's arbitrary, but it's reasonable. And as we look at
9 one- day and five-day and we look at how different a
10 cleared swap is from a future, is one-day the perfect
11 number in all cases; five-day the perfect number? No.
12 But to our mind, it's reasonable.

13 I just want to highlight a second issue that
14 we think is very important. And it may not be the
15 issue du jour that is discussed in this panel, but it's
16 worthy of mention. We are concerned still about the
17 possibility of jurisdictional disharmony with respect
18 to margins and specifically minimum margins. The RTS,
19 which is the rule set attached to EMIR, if I'm getting
20 all of the acronym soup right, is still not finalized,
21 but we're not clear yet that they are on the same
22 regime that we are here in the U.S.; i.e., one-

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1 day/five-day. And, no matter if it's one-day, five-
2 day, or half a day, three days, or whatever the number
3 is, boy, western Europe, at a minimum, and the U.S.

4 should have the same number or else you could
5 get some really odd regulatory arbitrage going on.

6 Thank you.

7 MR. RADHAKRISHNAN: Thank you.

8 Let me invite the commissioners. Have you
9 got any questions? Would you like to ask them? Okay.

10 So let me start off by telling you what the
11 Commission said in its proposing release for this
12 particular product. In the proposing release, which
13 appeared in the Federal Register on January 20th, 2011,
14 the Commission said a minimum one business day when
15 they talk about futures is the current standard that
16 DCOs generally apply to futures and options for futures
17 contracts. And that is why they propose one day. They
18 originally proposed one day for swaps that were going
19 to be traded on a DCM, if I'm not mistaken, but then,
20 based on comments, backed off on it.

21 Now, from a staff perspective, I'm going to
22 ask a question. And you folks tell me whether we are

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1 misinformed. I think staff is comfortable with one day
2 because it has been the practice, but also, all things
3 remaining equal, you can trace the growth in open
4 interest to volume, right, to transactions, which we,
5 the CFTC, have a view into because it's traded on a
6 DCM, all things remaining equal.

7 In the cleared swaps arena, we cannot do that
8 because I don't disbelieve you when you say that swaps
9 are liquid, but we don't have a view. CFTC doesn't
10 have a view.

11 Now, you could say you could subscribe to
12 screens and so on. To me, that is not the same. And I
13 know I am showing my bias, but I am very biased towards
14 our regulatory scheme. That is not the same as a
15 platform that Rick and his colleagues oversee as a DCM.

16 So what I'm asking is, is that a fair basis
17 to make the distinction or is that a fair basis for us
18 to have comfort that a futures portfolio can be
19 liquidated in one day because, all things remaining
20 equal, you know, we are comfortable, we have a view
21 into the liquidity or whatever you want to call it?
22 And, part two, assuming the Commission finalizes the

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1 SEF rules and you see swaps being made available to
2 trade, is that the time for us to rethink about the
3 one-day minimum for swaps insofar as they are traded on
4 a DCM or SEF?

5 MR. OLSEN: My first comment would be that a
6 single liquidation horizon that applies to all
7 instruments within one product set I think has natural
8 trade-offs and maybe an explicit recognition that there
9 is a portfolio effect. You will have some contracts
10 that are impossible to liquidate in one day, and you
11 will have others that are able to be liquidated very
12 quickly. And you are a bit reliant upon the
13 composition of any one, FCM's portfolio probably most
14 urgently and maybe by extension one customer's
15 portfolio.

16 So I think the analysis needs to move beyond
17 futures have this liquidity profile and swaps have that
18 liquidity profile. I think the micro structure of the
19 contracts, you know, my suspicion is if Kim's numbers
20 are right, if there are 30,000 participants in this
21 market, by relabeling in the future, I wouldn't suspect
22 that all 5 million futures participants will start

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1 trading that contract. They'll probably keep trading
2 the contracts that they were trading before.

3 So I think the determination should be made
4 on, what are the risk attributes at a more if not
5 contract- by-contract, at least sector-by-sector level
6 applied to both swaps and futures would be a productive
7 path.

8 MS. TAYLOR: I just want to explain a little
9 bit about how we apply that because I don't disagree
10 that -- it's not as simple as saying, "Here's the
11 margin requirement for all futures, and here's the
12 margin requirement for all swaps." And that's not the
13 way we look at it.

14 If you looked at the coverage levels that we
15 apply across the pool of futures that we clear, I think
16 you would find that in many cases, it is a one-day
17 coverage, but in many cases, it is a two-day coverage
18 or somewhere in between. It is more than the one-day
19 coverage, even on some of the very kind of largest,
20 most liquid products that we clear. The S&P, the
21 Eurodollar, both of those products are not set at the
22 one-day standard at this point in time. There probably

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1 have been points in time when they have been, but we're
2 at a very low-volatility environment right now. We
3 don't want to lower that all the way. We don't want to
4 go all the way down. So there are statistical factors
5 and there are judgment and experience factors that go
6 into assessing that.

7 As far as the points Dave was making about
8 the makeup of the portfolio, that is something that we
9 also address in ways that go beyond the minimum margin.
10 If we have got a very concentrated portfolio, we have
11 got a very concentrated product set, we have got a
12 clearing member with a big portion of the market, then
13 we have other tools that we can apply in addition to
14 the minimum margin. Sometimes the configuration of the
15 exposure will call for the market as a whole to be
16 margined at a higher level. Sometimes it will call for
17 higher margins to be targeted to the party that is
18 posing the heightened risk profile. So there are other
19 things in addition to the minimum margin levels.

20 And then you kind of made a point about some
21 products within -- you know, let's take the energy
22 product set as an example. Some products within that

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1 energy product set, highly liquid, central limit order
2 book, trade all the time. Some products don't trade as
3 frequently. And what we found when we needed to
4 liquidate a portfolio that included the whole spectrum
5 of those products is it was very easy to liquidate the
6 whole thing as a pool. And it all liquidated in -- I
7 think we gave people the final portfolio on the Lehman
8 portfolio at like 2:00 or 3:00 o'clock in the morning.
9 We held the auction at 8:00 in the morning, so 5 hours.
10 They were able to price that operationally, bring it
11 in, value it, and do their bids. And that included a
12 spectrum of, you know, futures with varying levels of
13 overall turnover.

14 MR. CAWLEY: Ananda, just to be clear, are
15 you saying that within the futures regime, you have an
16 observable market for liquidity and so, therefore, you
17 know what you know and you know you can liquidate at a
18 given day?

19 MR. RADHAKRISHNAN: All things remaining
20 equal -

21 -

22 MR. CAWLEY: Right.

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1 MR. RADHAKRISHNAN: -- because the Commission
2 has a view into trading, and so on.

3 MR. CAWLEY: Rick oversees it. So you know
4 it's a regulated marketplace and so on. But Rick
5 oversees the actual --

6 MR. RADHAKRISHNAN: Yes, yes.

7 MR. CAWLEY: Okay. So two things. One is
8 one has to be careful not to assume that just because
9 today it doesn't trade in an exchange, it's not
10 trading; right? Swaps are trading every day. So the
11 challenge, then, is how do you over -- you know, you
12 can't assume that. So how, then, do you measure that
13 liquidity in the marketplace today? And you can't just
14 walk away and say, "Well, it's not -- we can't see it.
15 So, therefore, it's not trading in a regulated
16 marketplace yet. So, therefore, we're just going to
17 assume the worst and assume that it is not trading."

18 The challenge is for you to go out and gather
19 that data. And that data is available. The other
20 thing is you need to be mindful that the SEF rules are
21 still not upon us. So you got this interregnum period
22 where there is still a lack of transparency in the

1 marketplace. And that is going to change.

2 So, to the second part of your question,
3 which is, you know, how do we observe it now but then
4 how do we account for it in the future, the simple
5 answer is, if you can pass the SEF rules quicker and
6 the market can then become more of an observable
7 marketplace with transparency and trade reporting and
8 so forth, then you're going to have a much better set
9 of data on which to base your decision. What I would
10 say, though, is I would recommend that you move, be
11 prepared to move, quickly and observe that quickly
12 into, you know, it doesn't become two years or three
13 years, it becomes a three-month or six-month event.

14 MR. MAGUIRE: Ananda, I think your challenge
15 is just as much our challenge as well as DCOs. You
16 know, we are risk managers ultimately. I think we have
17 a healthy paranoia around this. So we'll try not to be
18 too geeky as I try to explain what we do, but, look,
19 the past is maybe an indication of the future, but it
20 is by no means -- well, it has been very much prudent
21 in the past. That is not always the case.

22 So what we do every day, we are religious

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1 about back testing. We back test to a very high
2 standard, a very high confidence interval. And what
3 does back testing mean without getting too nerdy about
4 it? It means we look at the positions we have, not the
5 66,000 swaps we have with Lehman. You break that down
6 into positions that are analogous to concentration and
7 contracts and futures. You break that down into
8 positions. And you say, "How much would I need to
9 trade in the market to get out of this position?" And
10 what you are doing there every day is you are
11 challenging the assumptions of your margin model. We
12 say five days. As everybody said, it's arbitrary. We
13 have been doing five days for swaps since 1999. It
14 seemed to work okay in Lehman, but maybe it's time for
15 everyone to review it. You are challenging those
16 assumptions every single day across every single
17 portfolio.

18 And, to give you some context, when we closed
19 out Lehman, 66,000 trades just sounds like a lot of
20 clutter. We actually hedged out. We have 100 trades
21 in the market. So 66,000 trades doesn't mean 66,000
22 trades I have got to go hedge. It doesn't mean I need

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1 to go to 20 SEFs. It's actually quite easy to access
2 the market, even easier now with the opening up of the
3 execution venues.

4 So when we do this, we are really looking at
5 concentration, but I think the data that is available
6 to us is available to you as well. I know we obviously
7 share a DCO with you. I think it behooves all of us to
8 really get our hands around what is actually being
9 traded in the market. I think SDRs would hold that.

10 And I think the other thing is making sure
11 that all of these assumptions that we have via back
12 testing, concentration risk, that we actually test
13 these things. And we do things we'll refer to as fire
14 drills. And I think that is a very important way of
15 proving what is the right number.

16 And what are the qualifying criteria to all
17 of the 75 direct clearing members of swap clear is you
18 must participate every six months on a mandatory basis.
19 And we go and basically simulate a default, which to
20 anybody else, it's like simulating a disaster recovery-
21 type exercise. Our disaster's default. You simulate
22 that default. And every single participant has to give

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1 us prices to hedge the buck. We don't sell open risk
2 in the auction. We go into the market trade and hedge
3 the portfolio. We package it. Then we auction it. We
4 do that every six months. And those portfolios are
5 much bigger than Lehman, but also we have changed the
6 way we do this so everyone can participate and not
7 relative to their size and proportionality. But those
8 are the real tests. What are the prices you are
9 getting when you go to the market and you assume a dark
10 day, a high- volatility, low-liquidity day? You get
11 the prices. You see what the values of them is on the
12 hedge and the auction. And that is how we really prove
13 out to the best of our ability our assumptions and our
14 model, I think, you know, something we will continue to
15 share with the Commission, but I think that is another
16 way of really proving out whether five days, two days,
17 ten days is the right number.

18 MR. RADHAKRISHNAN: I wish we could continue
19 the discussion, but, you know, I have been told we need
20 to finish. So thank you very much.

21 And, you know, don't we have a record or
22 something? So if people want to send written

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1 materials, they should send it to us because it is
2 obviously not going to be the first time that we have a
3 discussion of this nature.

4 So come back at 1:30 or 2:00 o'clock? How
5 about 1:45. Split the difference, 1:45. And Panel
6 number 3 will start. So thank you.

7 (Whereupon, at 11:20 a.m, a luncheon recess
8 was taken.)

9 A F T E R N O O N S E S S I O N

10 MR. SHILTS: I think we'll try to get
11 started. I'm going to turn this over to Abigail Knauff,
12 who is going to start the third panel here. Abigail?

13 MS. KNAUFF: Hi. Panel 3 will focus on
14 transaction-related matters for swaps and futures,
15 including block trade provisions. We are interested in
16 hearing panelists' views on any challenges or issues
17 that resulted from the recent conversion of cleared
18 swap products to futures contracts for the Commission's
19 current block trade proposals. The Commission has
20 proposed a swap block trade, which has swap categories
21 and methodologies for setting appropriate minimum block
22 sizes for those categories and has also proposed

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1 acceptable practices governing the pricing and size of
2 block trades for futures.

3 We look forward to the discussion about any
4 issues or changes regarding consistency between swaps,
5 futures regulations to existing regulations, or to
6 future Dodd-Frank rulemakings.

7 Before we get into the discussion, I would
8 like to go around the table and have everyone introduce
9 themselves and identify who they represent.

10 MR. DURKIN: Good afternoon. I am Bryan
11 Durkin, COO of the CME Group.

12 MR. FARLEY: Thomas Farley,
13 IntercontinentalExchange.

14 MR. CALLAHAN: Tom Callahan, CEO NYSE Liffe
15 US.

16 MR. PESTONE: Wayne Pestone, Chief Regulatory
17 Officer, FXall, Thomson-Reuters Company.

18 MR. CAWLEY: James Cawley, CEO, Javelin
19 Capital Markets.

20 MR. LEE: Robert Lee, Deutsche Bank.

21 MR. THUM: Bill Thum, principal at Vanguard.

22 MR. HIRANI: Sunil Hirani, CEO of trueEX.

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1 MR. EMMITT: Bill Emmitt, President of PVM
2 Oil Associates in the U.S.

3 MR. BRADY: Neal Brady, Eris Exchange.

4 MR. JESKE: Jerry Jeske, Group Chief
5 Compliance Officer, Mecuria Energy Trading.

6 MR. WILSON: Don Wilson, DRW Trading and
7 Chairman of FIA PTG.

8 MS. KNAUFF: Thank you.

9 To quickly review the format, each panelist
10 will provide their prepared remarks for four minutes or
11 less. Once we hear the panelists' prepared remarks, we
12 will then start an open discussion. So that we can
13 hear from everyone, please hold your follow-up comments
14 until either your remarks or until after all panelists
15 have had the opportunity to make their prepared
16 remarks. And we will start with --

17 MR. DURKIN: Good afternoon. You know, in
18 just a little more than three months, the new swap
19 regulatory regime has had an acute impact on the energy
20 markets. Although NYMEX energy contracts have always
21 been listed as standardized futures contracts, many of
22 these saw very little trading activity in the listed

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1 markets because of the esoteric nature of many of the
2 products that we support. Instead, many of our market
3 participants relied on historically prevalent swap
4 execution protocols and then exchange that contract for
5 an economically equivalent product in our listed
6 futures. This trade type was permissible under the
7 Commodity Exchange Act and CFTC regulations because it
8 was accepted by the exchange and the exchange rules.

9 Facing an uncertain application of the new
10 swap rules last October, customers asked us for a more
11 flexible and certain means of executing our listed
12 futures contracts. In response, we permitted new block
13 trades and made more products available on our Globex
14 platform.

15 Now CME continues to support and we fought
16 hard to retain the EFS trading model, which allows
17 customers to retain their choice of transacting these
18 instruments via either OTC swaps, which will now be
19 subject to the CFTC regulations. We have adopted our
20 block levels to prevent significant disruption for our
21 customers while we were transitioning during this
22 period. We have seen a tremendous transition in many

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1 of our markets from OTC trade type to the exchange-
2 traded block. We believe that the thresholds that we
3 have established need to stay in place absolutely until
4 the full extent of the swap rules are clearly defined
5 and evident to the marketplace. We also need to give
6 appropriate time for the marketplace to adapt and
7 adjust to whatever that criteria is going to be.

8 By encouraging more blocks and movement into
9 the futures, our plans serve the regulatory interest,
10 we strongly believe, of transparency. The new block
11 trading allowed regulators and others to access real-
12 time transaction pricing and size data, which is
13 located on our website and is fully available through
14 our market data feats.

15 Additionally, we believe that the changes we
16 have made to our block thresholds not only avoided
17 market dislocation, but provided customers with more
18 choice and more flexibility.

19 As to timing, we firmly believe that the
20 Commission should first finalize the SEF and the market
21 available to trade rules before it considers block
22 rules for swap and futures. This is a logical sequence

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1 to avoid potential harm to our customers and to market
2 liquidity.

3 There's a lot of unknown questions that still
4 need to be clarified and validated: whether SEFs can
5 operate by voice or RFQ to one, rather than RFQ to
6 five, in the scope of the trading mandate, or the
7 impact that MAT rules will have on products, how they
8 will be required to trade on a SEF, and what will
9 dictate the role of blocks in those swap markets.

10 So one of the underlying principles that we
11 would like to leave for the distinguished panels and
12 the staff of the Commission is it is very, very
13 imperative that clarity be made in the context of the
14 SEF rules and the MAT rules. That will inform any
15 further decision-making. And in the meantime, clarity
16 is important to the marketplace, a marketplace that,
17 you know, has been operating with a certain level of
18 uncertainty, the transition I think has been very
19 seamless. We have been able to maintain the integrity
20 of that marketplace. And through the transitioning, it
21 is most definitely I think underscoring the imperatives
22 that you have outlined as a part of the rulemaking.

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1 MR. FARLEY: Markets have had the notion of
2 anonymous negotiation of trading privilege and
3 confidential portion of the market, if you will, for
4 ages. And they will continue to do so. And we
5 encourage staff to keep that in mind as you are
6 contemplating block trades, both for swaps and for
7 futures, and specifically ask you to consider the
8 important role of these trade types in managing
9 slippage for larger size trades to understand the
10 valuable role that brokers perform as part of this
11 function and, in particular, to understand the value of
12 block trades, particularly in a newer or more illiquid
13 market, where allowing block trades is a way to build
14 open interest, which is itself a way to build more
15 liquidity, perhaps paraphrasing a bit of what Don
16 Wilson said on an earlier panel that I won't belabor
17 because he is also on this panel, we think it is
18 important for staff to understand that these smaller
19 markets may well have a higher percentage of blocks
20 relative to the overall volume in that particular
21 market versus, say, a highly liquid market. Think of,
22 for instance, our Henry Hub futures contract versus --

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1 I don't know -- a more illiquid power delivery
2 location, for example.

3 I wanted to touch on quickly -- Commissioner
4 O'Malia asked a question about, well, what happens if
5 they're all blocks -- I'm paraphrasing; those weren't
6 his exact words -- and how do we address that? Could
7 we delist the contract or force it to migrate to a
8 swap? We think that is a bad idea. And we think that
9 would be disruptive. But we do think there are other
10 ways to deal with that issue and to work with the DCMs
11 and perhaps the SEFs to increase pre-trade price
12 transparency over time.

13 Just two final points. First, to the extent
14 there are rules for block sizes for SEF-traded markets
15 or even DCM-traded markets, we think it is imperative
16 that you leave it up to those SEFs and those DCMs to
17 determine those block sizes. That will be it perhaps,
18 subject to some guidance or some guideline that you put
19 forth, but we ask that you leave it in our hands to be
20 able to update that periodically from time to time
21 because, as we have seen in other analogous situations,
22 that set of shared -- or sharing the responsibilities

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1 in that way creates room for a little more innovation
2 and more rapid response time on behalf of SEF and DCM
3 managers.

4 That's all I have.

5 MR. CALLAHAN: My name is Tom Callahan. I am
6 the CEO of NYSE Liffe US, which is the U.S. futures
7 exchange or NYSE Euronext. We trade precious metals
8 futures, equity index futures, and interest rate
9 futures. I would like to thank the Commission for
10 giving me the opportunity to participate in today's
11 roundtable.

12 At NYSE Liffe US, we are focused on the
13 operation of our DCM. We don't have plans to launch a
14 SEF. Accordingly, we would like to emphasize that
15 whatever regulations the Commission adopts for SEFs, it
16 not unintentionally negatively impact the operation of
17 DCMs. It should be noted that DCMs functioned
18 admirably through the financial crisis. When the OTC
19 and other markets froze up, DCMs remained stable and
20 liquid. So when questions are raised regarding the
21 application of the same block trade regulations to DCMs
22 as they are imposed on SEFs, we are concerned that,

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1 once again, we are considering fixing something that is
2 simply not broken.

3 As noted by Commissioner Sommers, the
4 Commission in three different periods during the 2000s
5 addressed how DCMs should set minimum trade sizes for
6 blocks. Although language was tweaked and enhanced
7 over time, the theme remained the same. Block trade
8 thresholds should be set at a level which, given
9 liquidity for the trade, a trade would impact the price
10 of the market. We believe this concept should remain
11 the central guiding principle as it sets the right
12 balance to promote transparency without unduly
13 sacrificing liquidity. And we believe DCMs are best
14 positioned to make this judgment.

15 We are also concerned that reporting times,
16 particularly for our international equity index
17 futures, not be set so that liquidity providers are
18 unable to complete their hedges. And, also, they
19 should not apply to unexecuted, not held orders; our
20 global products involve 20 underlying markets
21 worldwide; and that hedging activity needs follow the
22 sun. Again, as Commissioner Sommers put it, we would

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1 not sacrifice liquidity at the altar of transparency.

2 MR. PESTONE: I am Wayne Pestone, Chief
3 Regulatory Officer of FXall, a Thomson-Reuters Company.
4 And I want to thank the Commission for inviting us to
5 participate. We intend to develop and register SEFs
6 and have devoted many resources over the past two and a
7 half years towards this goal.

8 Thomson-Reuters is concerned about the
9 regulatory arbitrage emerging between the futures and
10 swaps markets as a result of implementing the Dodd
11 Frank rules.

12 We note the disparate regulatory treatment
13 between futures and swaps with regard to margin, block
14 size, trade reporting, and the volume and thresholds
15 that trigger swap dealer registration. In each of
16 these cases, we think the right outcome is equal
17 treatment for economically equivalent futures and
18 swaps. Also, this equal treatment should occur at the
19 same time. In other words, if a precedent exists in
20 the futures market, the analogous swaps rule should be
21 consistent with this precedent until and unless the
22 Commission moves to change the precedent for both

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1 markets. For example, with regard to margin, we
2 believe the margin for cleared swaps and futures should
3 not be based on whether the instrument happens to be
4 called a future or a swap.

5 We ask that the Commission revisit the margin
6 requirements and make changes so that it's based on an
7 economic analysis of risk and liquidity such that
8 equivalent swaps and futures products have this equal
9 margin treatment. For blocks, we believe that the
10 block size determination should be equivalent for both
11 swaps and futures. Since the precedent so far is that
12 the DCMs can set their own block sizes, we think that
13 the SEFs as SROs should also be given this equal
14 authority. If after a year of the Commission analyzing
15 market data, it believes that the sizes should be
16 changed. That change should apply to both markets.

17 Thomson-Reuters views competition as a
18 catalyst for bringing the best possible experience to
19 all of our customers. We simply want the swaps markets
20 to be permitted to compete thoroughly with the futures
21 markets on appropriate playing fields. Regulatory
22 arbitrage between markets, especially arbitrage caused

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1 by the unintended consequences of a regulator's efforts
2 to improve one of those markets, doesn't create the
3 appropriate playing field to compete.

4 MR. PESTONE: Rather than asserting the swap
5 should simply have been traded exclusively on DCMs,
6 Congress created SEFs as part of the Dodd-Frank rules
7 as an alternative to the existing model. However, we
8 are worried that the swaps markets for SEFs won't be
9 viable by the time SEFs are ready to launch later this
10 year.

11 We're asking the Commission to allow the SEF
12 models to compete the SEF models to compete on an
13 economic and customer service round first. Therefore,
14 we request that the Commission delay the effectiveness
15 of listing any swaps futures contracts on DCMs until
16 the SEFs in each asset class are allowed to operate and
17 can compete fairly.

18 Thank you.

19 MR. CAWLEY: Thank you once again for
20 inviting me to participate on two panels this afternoon
21 and this morning. My name is James Cawley. I am Chief
22 Executive Officer of Javelin Capital Markets, an all-

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1 to-all trade execution venue. And, as I mentioned
2 earlier, for interest rate swaps and credit fall swaps,
3 it expects to register either as a SEF or DCM depending
4 on which way the rules come.

5 To consider what should be an appropriate
6 block trade rule for DCMs and for SEFs, we must first
7 remind ourselves of such a rule's purpose. We must
8 remind ourselves of the block rule where a market maker
9 is given an extended period of time before the block
10 trade is reported. It is designed to protect and
11 encourage liquidity, not to hamper or lessen it. Block
12 trade reporting delays encourage market makers to
13 provide liquidity in large size without fear that other
14 market players may abuse them as they hedge or trade
15 out of such a large position completely.

16 The block trade threshold test should be
17 objective and straightforward. For a given time delay,
18 the question is, what is the liquidity available to the
19 trader before he must report the block trade to the
20 market and be exposed? Too little liquidity within
21 such a time interval, and the trader does not have
22 enough time to get out of her hedge or trade out of the

1 position. She is exposed and could lose money. And
2 because of this risk, the trader is loathe to quote
3 such a large market next time.

4 Overall market liquidity is decreased as a
5 result. And the opposite is also true. Too much
6 liquidity within a given interval and the trader has
7 too much time to set a hedge. And he can now use this
8 price- moving information against the market. And, as
9 a consequence, liquidity is also lessened. And market
10 integrity suffers.

11 Thus, the block trade threshold should be
12 exactly equal to the amount of liquidity available to
13 the trader within the time interval or before she must
14 report the trade. The threshold should not be too
15 high, nor should it be too low. It should be just
16 right.

17 Available liquidity, moreover, does not just
18 include trades but also should include firm orders
19 available at the current price. In fact, the concept
20 of available liquidity goes further. It considers the
21 liquidity of other related markets. For example, if I
22 hedge interest rate swaps with Eurodollar strips,

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1 shouldn't I include the liquidity of that market in
2 consideration of the liquidity and block trade
3 thresholds for swaps? To be sure, the CFTC block trade
4 rule for SEFs does set the interval at 15 minutes in
5 the long run. And it does consider trade data in
6 setting the block trade notion or threshold, but it
7 does not yet consider price order data, nor does it
8 consider liquidity from other economically equivalent
9 markets. It should, and it would be a better
10 measurement if it does.

11 But in order for this to work, the same block
12 trade rule must extend to all trade venues, SEFs and
13 DCMs alike, for instruments within a given class of
14 economic equivalence to operate and function properly.
15 For example, interest rate swap futures and their
16 underlying swap instrument are economically equivalent.
17 And, that is, they are equivalent in risk and trade
18 relative to each other. And, as such, there should be
19 one block rules that governs both. And such a rule
20 should consider the available liquidity in both
21 markets. Neither SEF nor DCM but the CFTC should set
22 such a rule. And only then can the market be assured

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1 that the rule is objective, measured, and a realistic
2 measure of the available liquidity. One trade venue
3 must not be permitted to set its own rule while the
4 other has it set for them. Such a scenario clearly
5 raises the specter of a race to the bottom as market
6 forces may gain such a rule mismatching attempt to
7 force trades off market in a delayed reporting scenario
8 or report them not at all.

9 In conclusion, we need to remember the block
10 trade rules exist to encourage liquidity and
11 transparency. There should be no such thing as block
12 trade thresholds again that are too high or too low.
13 And there should be objective thresholds based upon
14 observable available liquidity in a given market that
15 considers also the liquidity in other markets
16 economically equivalent to it.

17 Moreover, such a rule would be set by the
18 regulator and not be applied in a uniform manner to
19 avoid any gaining or regulatory arbitrage but may
20 manifest itself between such markets. But such a rule
21 should be passed quickly along with other rules. And
22 in the interim, the CFTC should place a freeze on all

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1 futures certifications on products that may be
2 economically equivalent to products expected to be
3 traded by SEFs so as not to create an unfair advantage.
4 Such gaining can only lessen market integrity and drive
5 up execution costs on the end user.

6 Thank you. And I look forward to your
7 questions.

8 MR. LEE: Thank you and good afternoon. I
9 appreciate this opportunity to come before you to share
10 views and to contribute to the discussion of this very
11 important topic.

12 As the Commission works diligently to finish
13 its rules on swap execution facilities and block size
14 thresholds, I think it is important and appropriate
15 that the Commission take this time to acknowledge and
16 also consider recent developments in the swaps and
17 futures markets.

18 The topic of our discussion, you know, the
19 futurization of swaps, has generated a number of
20 commentaries that it had attempted to attribute reasons
21 behind this movement. You know, some pundits have
22 cited benign reasons, such as that this is a natural

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1 migration or a natural evolution of products. Other
2 experts have cited less benign reasons, such as that
3 this is borne out of concerns related to regulatory
4 complexity or new regulatory burdens and costs
5 associated with trading swaps. And others have also
6 said that, you know, the primary driver is regulatory
7 arbitrage or regulatory differences in the difference
8 between swaps and futures. I think, irrespective of the
9 reasons behind it, now that the topic of regulatory
10 arbitrage is before us and it is known to the
11 marketplace, it is known to the Commission, I think it
12 is sensible to take appropriate steps to address and
13 mitigate whatever potential there is for regulatory
14 arbitrage, right?

15 I think there are two critical areas that
16 have been identified by the Commission, you know, where
17 basically regulatory differences could distort the
18 competitive landscape and favor one market over
19 another. And those, you know, the first of which is the
20 setting of initial margins levels for futures versus
21 swaps, has been addressed by the previous panel. So I
22 will focus upon, you know, the block size threshold.

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1 I think in order to address any potential for
2 disparity in the treatment, I think a logical starting
3 place would be to look at the proposed rules on setting
4 block size thresholds for swaps. I think that is a
5 natural starting place, given that, you know, reporting
6 and SEF execution are new to the swaps marketplace.

7 When we actually look at the proposals for
8 the methodologies for setting block size thresholds for
9 swaps, I think if you were to look at the various
10 comment letters that have been submitted, I think one
11 underlying theme throughout is that there needs to be
12 better calibration, right, for the particular swaps
13 instruments in terms of setting the block size
14 thresholds. All right?

15 And I think, just as an example, where we
16 perceive some weakness in the proposed methodology is,
17 you know, in the credit space just as a starting point.
18 In the credit space, if you were to look at what is the
19 most liquid instrument, you know, that right now is the
20 five-year contract on the under-run series of the
21 index. Right? Whenever there is a role, which occurs
22 with every six months, the liquidity of what used to be

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1 the under- run series drops dramatically. And six
2 months later on, it drops even further. However, the
3 way that the methodologies treat these instruments is
4 to actually lump them all together within the same
5 maturity bucket. As such, you combine both liquid as
6 well as illiquid swaps into the same bucket. And that
7 has the effect of actually overstating the amount of
8 liquidity for the less liquid products. And,
9 therefore, the block size thresholds may be set
10 inappropriately for the less liquid instruments.

11 And I think, similarly, in interest rate
12 space, when you look at a ten-year fixed or floating
13 swap, which is very liquid, and you pull it together
14 with a six-year or seven-year, eight-year, or nine-
15 year, which are less liquid, you have the same effect
16 here.

17 And so I think a reasonable starting place
18 when we actually look at and reevaluate the
19 methodology, I think there should be a clear
20 distinction between what is liquid versus illiquid,
21 right, in order to, you know, satisfy the statutory
22 mandate, which is to really take into account the

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1 impact of liquidity based upon public disclosure of
2 information.

3 So, you know, if we were to start looking at
4 how we would actually go about it, I think there needs
5 to be perhaps more granular analysis of various
6 contracts, I think a clear differentiation between
7 illiquid and liquid products, maybe narrowing of the
8 buckets so that you actually isolate liquid from
9 illiquid products. And, you know, I think it's
10 understandable, but for operation and administrative
11 ease, some bucketing would be appropriate, right? But
12 I think it is really trying to highlight that within a
13 bucket, there are less liquid instruments and by
14 conforming the block size thresholds to the more liquid
15 instruments within that bucket, you will deprive the
16 market of valuable liquidity in the less liquid
17 instrument.

18 I think another aspect that I think has been
19 alluded to by other panelists is the question about who
20 actually determines ultimately the size of the block
21 size thresholds. And I think that is a reasonable
22 question, but I think what is more important to the

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1 marketplace is to figure out what are the common
2 principles behind how that is actually determined. And
3 I think there should be a common sense approach in
4 terms of setting the basic guidelines. You know, for
5 example, first and foremost, the block size thresholds
6 for any particular instrument should really be
7 reflective of its liquidity in the marketplace. You
8 know, I think that is pretty obvious.

9 I think the second principle should be that
10 less liquid instruments should have lower block size
11 thresholds. And, once again, that is very common
12 sense, but if you were to look at some of the proposed
13 block size thresholds, in the proposal, it is
14 counterintuitive if you were to look at it.

15 And I think a third principle, which I think
16 is not very controversial, is that when you start
17 grouping instruments into a maturity bucket, I think we
18 really should look to the least liquid swaps
19 instruments within that bucket to determine the block
20 size threshold. Otherwise, I think you will overstate
21 the liquidity for that illiquid instrument. And you
22 would end up setting an inappropriately high block size

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1 threshold for that instrument.

2 And I think, you know, as everybody would
3 agree, can agree on, I think you need to have a vibrant
4 swaps market as well as a futures market. They
5 essentially complement each other. And by having, you
6 know, areas where there are potentials for regulatory
7 arbitrage, you effectively, you know, have regulatory
8 bias dictate where liquidity goes, rather than true
9 market forces.

10 Thank you.

11 MR. THUM: So, again, I am Bill Thum from
12 Vanguard. Just to remind the audience, Vanguard is on
13 the buy side. We are a real money manager with over \$2
14 billion under management and 9 million shareholders. We
15 use swaps to carefully hedge portfolio risk, to lower
16 transaction costs, and to achieve more favorable
17 execution as we manage our portfolios. We have been
18 very big supporters of the CFTC's rulemaking efforts,
19 particularly with respect to non-public reporting, some
20 of the margin rules, and as well the clearing of swaps
21 and the enhanced customer protection for the margin
22 that is held for cleared swaps, but we question whether

1 the development of the swaps futures products suggests
2 the CFTC's proposals are expected to negatively impact
3 the swaps market overall liquidity.

4 With respect to swap futures, we, like other
5 asset managers, are intrigued. The pros, of course,
6 are lower initial margin levels and lower block sizes.
7 However, we have questions with respect to liquidity in
8 the product and also the ability to use the product to
9 adequately tailor the hedges to match the risks
10 presented by our portfolios.

11 The initial margin of two days of VaR is set
12 by the clearinghouse based on its overall confidence
13 with respect to pricing, hedging, and liquidation. And
14 low block sizes are closely attuned to the trade size
15 participants can hedge in 15-minute intervals. This is
16 instructive as we evaluate the swaps regulations.

17 For the swaps initial margin under the
18 current proposal for cleared product is a five-day VaR,
19 and the clearinghouses have acknowledged in previous
20 panels that a longer period is needed to have
21 confidence with respect to pricing, hedging, and
22 liquidity given the limitless variations on the swaps

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1 market. However, the disparity between a two-day VaR
2 for swap futures and a five-day VaR for swaps, cleared
3 swaps, is pushing participants toward increasingly
4 considering swap futures.

5 Now, as a proposal to particularly focus on
6 setting initial margin levels based on relative
7 liquidity, one could consider an alternative approach
8 where for the most liquid products, a two-day VaR would
9 apply to swaps that were mandated for clearing, as
10 opposed to swaps that are optionally cleared. A three-
11 day VaR could apply to the swaps that would be optional
12 clearing and a five-day VaR for uncleared swaps. In
13 setting the VaR in this way, you recognize the relative
14 liquidity presented by the products, and you also avoid
15 the arbitrage between swap futures and swaps.

16 As Vanguard hedges its portfolio, we look to
17 hedge the overall risk presented by the portfolio. Swap
18 futures, which will naturally hedge a more limited
19 range of risk, may be attractive to us, but in
20 executing a swap future, we will have to also focus on
21 the risk at the tail and at the head as we consider it.
22 So we want to make sure that we are driven by the

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1 proper considerations in constructing the hedge and not
2 simply because of an arbitrage based on initial margin
3 or lower block sizes.

4 In terms of the block thresholds, we have
5 repeatedly come to the Commission and said, "The
6 current proposals do not adequately reflect the
7 relative liquidity nor the impact on liquidity that the
8 block, the current proposals, could have." While we
9 also think the current 30 to 15-minute public reporting
10 delay is too short to actually hedge positions, we
11 recommend a number of changes with respect to the block
12 threshold approach.

13 First of all, treat all trades as blocks for
14 the initial year while information can be gathered.

15 Secondly, study the data from the SDRs to
16 determine both the categories based on differentiated
17 liquidity buckets.

18 And, rather than run through examples, I will
19 turn your attention to the May comment letters
20 submitted by the ICI, by SIFMA AMG, and by ISDA, as
21 well as our own letter from May that illustrates the
22 many additional levels of granularity that we think

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1 should be applied in assessing blocks.

2 Fourthly, set relative block thresholds based
3 on the volume that could be executed immediately
4 without moving the market. In other words, we want to
5 be able to put trades in that are not blocks where we
6 can expect the dealer to hedge its position immediately
7 without impacting the price that it charges to us.

8 Fifthly, refresh the block sizes quarterly.
9 The current proposal simply has too long a period to
10 refresh the assessment of the relative liquidity.

11 And, finally, report trades above the cap at
12 the block level.

13 So, finally, when the CFTC sets more granular
14 categories and establishes relatively appropriate block
15 sizes, keep in mind that market participants such as
16 Vanguard will still need to break trades into sizes
17 that can be hedged in that 30 or 15-minute period to
18 avoid pricing disruption. This may add significant
19 costs to our execution, costs will, of course, be borne
20 by our shareholders. The costs will include having to
21 execute multiple small trades, which will increase
22 transaction costs. And, indeed, as we execute

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1 subsequent trades, the price for the subsequent trades
2 will be impacted by the trades we put on initially.

3 Vanguard's trading draws on the need to hedge
4 across multiple portfolios. We aggregate the hedging
5 needs and try to execute a single trade to cover the
6 hedging across all the portfolios, then allocating the
7 trades to distribute the hedging. If we have to break
8 those trades up, we will obviously incur additional
9 costs associated with that and possible pricing
10 differences.

11 So thank you again for inviting me to speak
12 and will be eager to answer any questions.

13 MR. HIRANI: Hi. I'm Sunil Hirani again of
14 trueEX. Thank you very much for inviting me to
15 participate in this roundtable to talk about some of
16 the salient aspects of Dodd-Frank relating to swaps and
17 futures.

18 TrueEX is the first regulated exchange
19 approved as a designated contract market by the CFTC
20 initially for the interest rate market. And trueEX's
21 goal is to provide a safer, more efficient, open
22 exchange, as outlined by Dodd-Frank mandates to create

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1 a transparent, competitive, regulated marketplace for
2 standardized swaps and the clearing of those
3 transactions, and also to provide consumers with a
4 choice of clearing, which we have done.

5 And, you know, one of the reasons we created
6 trueEX as a DCM regulated by the CFTC is of clearing,
7 which we have done.

8 And, you know, one of the reasons we created
9 trueEX as a DCM regulated by the CFTC is for the
10 express purpose of listing both swaps and futures
11 because our view is that consumers, like Bill, are
12 going to choose over time which instruments they want
13 to execute and where they get better liquidity and
14 execution and cost.

15 So creating a DCM, we believe, is going to
16 allow us to leverage the benefits that have long been
17 enjoyed by the futures markets to be utilized by the
18 \$600 trillion interest rate swap market. We need a
19 CFTC- regulated exchange, like trueEX, that provides
20 all the benefits of futures to standardized swaps,
21 including pre- trade transparency, trading on a
22 regulated venue; i.e., DCM, post-trade transparency,

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1 true end-of-the-day close, anonymous execution with a
2 fully cleared model.

3 So I'd like to make two primary points. And
4 they dovetail very nicely with some of the comments. My
5 first point relates to those classes of swaps that are
6 very liquid, that are very standardized, that trade on
7 a transparent exchange, that are cleared, that are very
8 much futures-like. And so for those classes of swaps,
9 not for every class of swaps, but for those classes of
10 swaps, we would encourage the CFTC to craft a
11 regulatory framework that treats a standardized swap,
12 which is futures-like, similar to the framework that
13 has existed and worked extremely well in a futures
14 market for a long period of time, as long as the
15 futures contract is equivalent in terms of risk, time
16 for liquidation, volatility, pre-trade transparency,
17 and clearing. But, as things stand today, even if a
18 swap is traded on an exchange, on a DCM, with the full
19 benefits of transparency and equivalent risk, time for
20 liquidation and clearing, it is not equal to a futures
21 contract and for an equivalent amount of product
22 standardization because there has been some discussion

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1 in the previous panels. So I am not arguing that
2 products that are not equivalent from a product
3 standardization perspective should be treated
4 similarly, but those contracts that are equivalent from
5 a product standardization perspective, risk, liquidity
6 and transparency, and hopefully regulatory oversight
7 should be treated in a similar and consistent fashion.

8 My second point relates to those classes of
9 swaps that are not liquid nor are standardized. And
10 for those classes of instruments, it is necessary for
11 market participants to trade them off the run or in a
12 block fashion, you know, life cycle events that cannot
13 be easily captured in a manner that I described the
14 first class of transactions. Swap traders need to be
15 able to terminate preexisting swaps. They need to be
16 able to novate them and compact them. In looking at
17 some of the recent SDR data and entry-level market
18 information, you know, a majority of the clearable
19 swaps of the reportable clearable swap transactions
20 were done actually in off- the-run instruments that
21 were either terminations, trading old series,
22 novations, or unwinds. And for these classes of non-

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1 standardized swaps, we must allow swap market
2 participants to execute them off the run, similar to
3 how it happens in the futures markets on DCMs. And
4 CFTC should ensure that these transactions can be
5 executed on regulated DCMs in a manner similar to what
6 is permitted for futures, such as blocks, exchange for
7 physical, and exchange for risk transactions.

8 In the futures markets, new order types are
9 permitted to execute less liquid or block transactions
10 off facility. Once again, we would request nothing
11 better but just similar treatment to futures on a DCM.
12 As long as standardized swaps are traded on a DCM on a
13 transparent, cleared, and anonymous basis with
14 equivalent regulatory oversight, similar to futures,
15 they should enjoy all the benefits as well as the
16 obligations of a similarly traded futures contract on a
17 DCM, which what matters is what is substantive about a
18 financial instrument, not the name of the wrapper or
19 the package in which it is delivered.

20 The objective of the act was to regulate
21 swaps in a manner similar to what has worked extremely
22 well in the futures markets for so many years. It is

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1 incumbent upon the regulators to ensure a vibrant,
2 well- functioning, transparent, and regulated not only
3 futures but swaps market as well for a lot of the
4 reasons that Bill and others have talked about and to
5 ensure consistency in regulation and treatment so
6 people and firms that utilize these instruments for
7 risk management, they are in the best position to
8 choose which wrapper they would like their risk to be
9 packaged in.

10 Thank you very much.

11 MR. EMMITT: As I said before, my name is
12 Bill Emmitt and I'm president of PVM Oil Associates in
13 the US. I appreciate the opportunity to share my views
14 on the futurization of swaps and the role of voice
15 brokers in the energy markets. PVM is an international
16 voice broker specializing in over-the-counter and
17 futures execution services in the energy arena.

18 We have been in business for over 40 years,
19 serving a diverse institutional client base, including
20 integrated oil companies, independent refiners and
21 producers, physical traders, banks, hedge funds,
22 proprietary traders and national oil companies. Our

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1 primary markets involve crude oil and refined products
2 traded in futures, derivatives and physical markets.
3 Many of these products are illiquid and do not trade
4 actively on a central order book.

5 In addition, I'm also here representing a
6 coalition of energy voice brokers who have come
7 together to express their common interest in preserving
8 their ability to serve our customer base in an every-
9 changing regulatory environment. Although diverse in
10 style and market specialization, we have many traits in
11 common. We are small business enterprises, privately
12 owned, entrepreneurial, experts in our chosen market
13 segments, competitive and, most importantly, we all
14 enjoy an extensive institutional customer base across
15 all areas of the energy trading space.

16 As the CFTC implements new regulations under
17 Dodd-Frank, we are facing new challenges to providing
18 execution services to our clients; first, with SEF
19 rules favoring large, public companies with sufficient
20 capitalization to open their own SEFs, and then, with
21 the unilateral migration of most of our OTC derivative
22 products to futures market.

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1 First and most significantly, our customers
2 have spoken and are supporting the trading and clearing
3 of swap futures. We support this migration and urge
4 the commission to allow the active participation of
5 voice brokers in these markets. Going forward, the
6 CFTC should not impose any barriers to using futures as
7 a means to force market participants to use swaps.

8 The decision to trade in a particular
9 contract should be based on the needs of the customer,
10 not on the regulatory requirements imposed by the CFTC.
11 To that end, we urge the continuation of current block
12 sizes for futures and options. As outlined in the
13 comment letter submitted by the Energy Voice Broker
14 Coalition, we believe that the CFTC should monitor
15 trading volumes on these converted OTC products, as
16 well as related options contracts, to better judge the
17 appropriateness of the assigned minimum block sizes.

18 The CFTC should analyze a significant volume
19 of trade data accumulated over a long period of time,
20 at least one year, from both DCMs and SEFs. This
21 analysis should look at the size and frequency of
22 trades, daily volumes and consistency of resting bids

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1 and offers to the extent that trading activity grows.
2 Then the CFTC can monitor the growth the data provided.

3 A particular contract, futures, options or
4 swaps, could be required to trade on the CLOB. Many of
5 the swaps that were recently converted to futures by
6 CME and ICE remain very illiquid and there is often no
7 alternative mechanism for execution other than voice
8 broker-arranged transactions that are then executed as
9 block trades. If the minimum size for block trades for
10 illiquid products is raised, there will be negative
11 consequences for customers seeking to hedge or risk
12 manage and for the markets in these products more
13 generally.

14 As a result, our customers risk not being
15 able to enter into customized block transactions and
16 will not or cannot enter into transactions because on a
17 screen because, one, there are no or few bids or offers
18 on the screen and they will not want to expose or
19 telegraph their trades, trading strategies or, two,
20 standard products are not tailored to their specific
21 risk management needs, such as structured products with
22 multiple legs.

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1 Many of these products have been illiquid for
2 many years. Forcing them to a CLOB, if possible, will
3 not create liquidity. These are thin markets with
4 infrequent trades. Forcing end users to the CLOB will
5 drive them elsewhere, which will reduce and ultimately
6 eliminate any liquidity in these products.

7 We strongly believe that there must be
8 consistent block rules for trades on SEFs and DCMs,
9 which should be tailored to the features of the
10 contract being traded, such as type of asset, class,
11 liquidity and depth of market, and not the venue on
12 which it trades.

13 Furthermore, a voice broker should be
14 permitted to arrange block trades on SEFs as well as
15 DCMs. In this regard, we urge the CFTC to confirm in
16 the final SEF rules if voice brokers are permitted for
17 transactions that are not available to trade. We
18 believe that the CFTC, and not a SEF, should make the
19 determination as to which swap should be made available
20 to trade. Otherwise a SEF is as -- is incentivized to
21 certify that a swap is available to trade, even if that
22 swap is relatively illiquid and does not actively trade

1 on a SEF.

2 Finally, block trade sizes should not be
3 determined by notional value. Instead, they should
4 take into account the particular features of the
5 contract. If a contract is not liquid and, therefore,
6 is not actively traded on a screen, the block trade
7 threshold should reflect those factors.

8 I appreciate the opportunity to participate
9 today and I look forward to answering any questions.

10 MR. BRADY: Thanks. Neal Brady from Eris
11 Exchange. You know, on this topic there's a lot of
12 discussion, a lot of bandying about of the term, you
13 know, level playing field. And as, you know, Professor
14 Parsons in the opening session mentioned, I mean, while
15 that's a tempting sort of slogan and framework with
16 which to look at -- look at this -- an issue like this
17 -- and some of the others were talking about today with
18 this one in particular, the reality unfortunately -- or
19 the reality, in fact, is just -- it's quite different.

20 I mean, Congress, you know, intentionally set
21 up two very different frameworks and two very different
22 playing fields, if you will, to oversee both swaps and

1 futures. And there's -- you know, there's an
2 underlying rationale for those very different playing
3 fields. And we at Eris Exchange believe that's the
4 framework with which to, you know, look at -- look at
5 this issue of block thresholds.

6 So I'll talk just about one overlying concept
7 related to that and then give two specific examples. In
8 a -- in a swap framework, as I think we're all aware,
9 the execution guidance allows for an extreme amount of
10 flexibility. And there's a reason for that, given the
11 nature of the customized nature of swaps.

12 In the DCM framework, there's very specific
13 guidelines around how executions occur below the block
14 threshold -- and I'll walk through some specific
15 examples around that -- that, you know, do not apply to
16 SEFs. And then in setting block thresholds, the
17 commission has provided guidance around nine principles
18 which the DCM should use for futures contracts and set
19 those thresholds.

20 And notably, you know, one of those nine
21 principles includes, you know, the block thresholds and
22 comparable SEF products. So at Eris, you know, we're

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1 supporters of the -- of the rule and that proposed
2 rule. We think it works and it's worked in practice and
3 it works -- it will work going forward.

4 So two specific examples -- you know, a lot
5 of the discussion focuses on what that block threshold
6 is and what happens above that block threshold but it's
7 worth just pausing for a moment to talk about and be
8 very explicit and clear about what occurs below the
9 block threshold and what's required below the block
10 threshold.

11 You know, at Eris Exchange our other futures
12 -- DCMs, we have a central limit order book. We have
13 an anonymous central limit order book. We have stacked
14 bids and offers that are fully transparent. Executions
15 occur in, you know, a submillisecond timeframe and are
16 reported instantly to the marketplace.

17 Importantly, RFQs for off the run -- or
18 customized structures, those are -- those RFQs are seen
19 by everybody on the platform. Anyone can participate
20 in the response to that RFQ. Anyone can step inside of
21 the best bid and offer and the matching occurs
22 according to that price-time priority. So a very, very

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1 different framework than the framework that's been laid
2 out for SEFs, whether that ends up being, you know,
3 send it -- send it to five -- the RFQ to five people or
4 send it to three.

5 We think there was -- even within Congress in
6 setting up these frameworks was intentional about doing
7 that. So just to us, to talk about equivalency and
8 that the threshold should be identical in the two
9 venues, it just doesn't make a lot of sense. Should it
10 be one of the factors considered in, you know, in DCM
11 setting block thresholds? Sure, and that's already in
12 the DCM -- you know, the proposed guidance.

13 Second, you know, major sort of area to
14 clarify is clearly Congress mandated for swaps and SEF
15 execution multiple venues. I mean, there are -- there
16 are multiple SEFs trading the same -- the same
17 contracts. So to take that in practical terms, if a --
18 if a client were executing a \$500 million interest rate
19 swap, that could be cut up into five different RFQs on
20 five different SEF platforms with, you know, five
21 different sort of ways of operating or protocols that
22 allow for, you know, purposely and intentionally a

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1 maximum amount of flexibility.

2 If you mapped that over into the futures
3 example, that one \$500 million trade in an interest
4 rate swap future that would be occurring on a single
5 venue would have a larger impact as a single trade
6 moving the market. There's more flexibility in a SEF
7 in a swap arena. Therefore, it seems quite logical to
8 us and intentional that the, you know, that the
9 thresholds could be -- could be higher because what's
10 allowed under the threshold is a lot more flexible.

11 So I'm happy to answer questions and engage
12 in a dialogue but, in conclusion, we just -- we support
13 the framework that's been laid out by the commission
14 and believe there's very strong Congressional intent on
15 setting up two distinct frameworks.

16 MR. JESKE: Good afternoon and thank you for
17 inviting us to speak here today. My name's Jerry
18 Jeske, group chief compliance officer for Mercuria
19 Energy Trading. We are an energy end user. Our
20 operations span 50 countries and over 40 offices with
21 facilities as well a general office space.

22 We invest in upstream assets. We manage

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1 midstream operations. We ship, store, blend and
2 transact in the physical commodities, including crude,
3 refined products, fuel oil, coal, biofuels, emissions,
4 natural gas, electricity and base metals. Along with
5 this activity comes a need to manage price risks. In
6 order to manager our commodities-related risks, we are
7 dependent upon the standardized futures contracts, as
8 well as the OTC Derivatives Markets. We are customers
9 of both the exchanges and the broker community.

10 I'm representing our firm here today because
11 we understand the needs of both the exchange community
12 and the broker community. We strongly believe that the
13 Commission should refrain from trying to fix something
14 that is not broken. In other words, block trading is
15 working. The marketplace and the exchanges have done
16 an excellent job in administering the block limits and
17 have struck the appropriate commercial and regulatory
18 balance.

19 Block trading activity is cleared, reported,
20 transparent, meeting the goals that were established by
21 Congress through Dodd-Frank. Dodd-Frank's aim was to
22 bring transactions in the OTC marketplace and that --

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1 to regulated clearing houses, SEFs and DCMs. That's
2 exactly what's happened in the energy market.

3 Migrating EFS to blocks in the past few
4 months has been successful. As a result, the CFTC
5 should embrace the success and declare victory. The
6 existing futures regulatory regime provides firms like
7 ours with legal certainty newly developed swap regime
8 presently cannot offer.

9 It certainly defies logic to conclude that
10 Congress intended for the CFTC, through rulemaking, to
11 now force market participants from legally certain
12 futures markets onto untested swap platforms, resulting
13 in added commercial and legal risks, simply to become -
14 - to avoid the cumbersome EFS mechanism, which has now
15 been abandoned for the more streamlined block mechanism
16 that's been administered.

17 For the CFTC to attempt to manage block
18 thresholds with limited staff resource and over 1000
19 different contracts in various asset classes and try to
20 fit a one-size-fits-all methodology, we fear will be
21 disastrous, which would also lead to the possibility
22 for companies like ours to seek venues outside of the

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1 US.

2 As the commission knows, every market is
3 different and the value of the core principles regimes
4 allow registrants the ability to be flexible, tailor
5 the rules to fit the characteristics of numerous
6 markets. A particular example is the electricity
7 markets, where the exchanges have worked with the
8 industry to craft six different lot sizes for
9 commercially appropriate reasons.

10 What we feel that has been overlooked is
11 Section 3 of the Commodity Exchange Act. The very
12 purpose of the CEA specifically states, "Transactions
13 subject to the act are entered into regularly in
14 interstate and international commerce and are affected
15 with a national public interest by providing a means
16 for managing and assuming risks."

17 Prior to the CFMA of 2000, the CFTC used to
18 utilize an economic purposes test to determine if a
19 futures contract should be listed. The economic
20 purposes test assessed the contract's ability to
21 transfer or hedge risk. We suggest that risk
22 transference is paramount to the well functioning

1 markets.

2 Price discovery is secondary and should not
3 be the final outcome necessary to list futures
4 contracts or to force arbitrarily high block levels.
5 Thus, the utility for end users and ultimate commodity
6 consumers would be in peril. Current block trading
7 provides the essential ability of parties to transfer
8 risks from ones that do not want to manage that risk to
9 ones that are willing to take on such burdens.

10 We respectfully request that the CFTC
11 guidance in this area should be strictly limited to an
12 evaluation of whether a DCM evidences good faith
13 efforts to support competitive, well functioning
14 markets and allow commercial end users and other market
15 participants access to clear their risk.

16 In sum, and to answer some of the staff
17 questions that were presented earlier, any perceived
18 differences between the futures and swap regulatory
19 regimes are a red herring intended by parties to gain
20 commercial interests for economic advantage. Block
21 trading has been successfully administered by the
22 exchanges from a commercial and regulatory perspective

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1 and should not be tampered with.

2 Proposed Rule 38.502(a) is a very bad idea.

3 The so-called 85 Percent Rule should not come into
4 force. Block limit sizes should be managed by those
5 closest to the market participants needing to recognize
6 that each commodity asset class is different and must
7 be analyzed closely by market participants with their
8 involvement.

9 Markets could easily vanish or move offshore
10 if not treated appropriately. Thank you.

11 MR. WILSON: Thank you. I'm Don Wilson,
12 founder and CEO of DRW. I'm here representing the FIA
13 PTG. The members of FIA PTG are supportive of block
14 thresholds, which are appropriately sized. There's
15 ample evidence that blocks -- block thresholds which
16 are too low harm the central limit order book and
17 encourage internalization and payment for orderflow. On
18 the other hand, block thresholds that are too high make
19 it difficult for large market participants to
20 efficiently consummate large transactions and move
21 large amounts of risk efficiently.

22 FIA PTG also supports the notion that block

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1 thresholds may, in some circumstances, be different
2 between swaps and futures. The reason for that is that
3 the regulatory regime for swaps is very different than
4 the regulatory regime for futures. Let me talk about
5 some -- let me highlight some of the important
6 differences.

7 Although the SEF rules have not yet been
8 finalized, we know that SEFs will have very flexible
9 transaction rules for RFQs, while DCMs do not. An RFQ
10 on the SEF is a private interaction between a very
11 limited number of market participants. Current -- the
12 current rule proposes five. Some market participants
13 have suggested that a one-to-one RFQ is appropriate. To
14 be clear, a one-to-one RFQ is a block trade by a
15 different name.

16 On the other hand, on DCMs and futures, an
17 RFQ goes out to the entire marketplace, so that
18 everybody can respond to the expression of interest to
19 transact. Because of this very high degree of
20 flexibility afforded to SEFs for transactions not
21 considered blocks but also not consummated in the
22 central limit order book, it is reasonable that SEFs

1 are subject to relatively high block thresholds
2 compared to futures.

3 Because identical swaps, including swaps
4 which are cleared at the same clearing house, can be
5 transacted on different venues, unlike futures, which
6 are, of course, a vertical model, it is reasonable that
7 the CFTC should be responsible for setting the block
8 threshold for all swaps.

9 Furthermore, because a block is just a
10 privately negotiated transaction and really isn't
11 transacted on a platform, it is important that DCMs
12 that list swaps are held to the same block threshold as
13 the SEFs for the same swap. The de facto block
14 threshold for a given fungible swap is equal to the
15 lowest block threshold for that swap, regardless of
16 venue.

17 So in summary, it's my belief that the CFTC
18 is going down the right path in distinguishing the
19 framework that's used to determine block thresholds. I
20 also believe that the CFTC should stick with the
21 historical approach of applying Core Principle 9 to --
22 as guidance to DCMs in setting block thresholds for

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1 futures, rather than applying a one-size-fits-all
2 mechanism to the futures markets, which is simply
3 unnecessary because of the vertical relationship
4 between the DCM and DCO in the futures space. Thank
5 you.

6 MR. SHILTS: Okay. Thank you all.
7 Commissioner O'Malia, do you have -- do you have a
8 question?

9 COMMISSIONER O'MALIA: I just want to ask one
10 to start. And there was discussion about, you know,
11 getting block sizes right, not too small, not too
12 large, that there should be a function of liquidity, et
13 cetera. And I -- the question is maybe to the
14 exchanges but to anybody is that -- I guess myself and
15 I think the staff had always kind of viewed blocks
16 meaning large, you know, transactions that are large
17 relative to something -- usually relative to trading on
18 a centralized market.

19 And as you get -- as we've seen in some of
20 the energy products, where blocks are, you know, very
21 low, five, two, one, then it kind of -- I just, you
22 know, wondered, what do people think of in terms of the

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1 relative to what? You know, it's large relative to
2 what? If you -- particularly if you have a block that's
3 only two or one, it's essentially the same as the
4 contract size.

5 So in some sense, it seems as though the term
6 "block" has another meaning, I mean, as illiquid or
7 something and not really large. So I just -- I don't
8 know if anybody's got any comments on that or thoughts
9 on that.

10 MR. WILSON: Go ahead, Bryan. Yeah, I think
11 it's a question of large compared to the size of the
12 central limit order book in a given product. And the
13 energy market is a very interesting example. I think
14 that perhaps the block thresholds in the energy market
15 right now are not sufficiently granular. Certainly in
16 a front month product that's very liquid, it's entirely
17 reasonable to set a block threshold that's higher than
18 for a month that's difficult to price, that's very
19 opaque, is difficult to source liquidity in and doesn't
20 - - just doesn't exist on the screen.

21 MR. JESKE: Rick, maybe I can jump in since
22 Don mentioned energy. Not to be cliché, size matters.

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1 But the liquidity that people are speaking of, I think,
2 is paramount. I use the example of electricity. You
3 have megawatt hours. You have nodes that are being
4 traded around this country. There are tremendous
5 amount of illiquid potential products out there.

6 So how do you put a buyer and a seller
7 together? Do you force them to go to the central limit
8 order book for the sake of price discovery? I say not.
9 I say you allow those counterparts to come together,
10 whether it's through a voice broker or through an
11 exchange, to have the ability to be able to make that
12 transaction transparent.

13 But when you only have two people in the
14 marketplace or three or four or five, they need to be
15 able to seek one another out. And for the commission
16 to actively set an arbitrary number is just -- will
17 destroy the markets -- in the small markets, as well as
18 those that could develop into larger markets. So when
19 you -- when you get to the concept of size, I think
20 that's secondary. I think you really have to look at
21 the type of market.

22 MR. DURKIN: Having recently gone through

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1 this in, you know, great, laborious detail, I would
2 agree with both of actually what Don and Jerry stated.
3 I mean, you have to look at -- when you're talking
4 about over 1000 products in the energy space that
5 you're trying to respond to a marketplace that has
6 obviously spoken loudly that there is a need for these
7 risk management tools, and you look at the more liquid-
8 type contracts that are bit more conducive to a CLOB-
9 like environment, you will see a greater correlation of
10 higher block thresholds associated with those
11 particular products.

12 As you move into some of the other more
13 esoteric products, and particularly, as you're dealing
14 with options that are linked to a variety of other
15 energy- related instruments, it becomes a bit more
16 complex. And your -- you know, your realm of user base
17 and the liquidity associated with that could be as low
18 as what Jerry had just described. And so that
19 predicates a lower threshold.

20 You know, when we went through this for the
21 conversion of all of our products, we did do it in --
22 there was a semblance process that we went through. And

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1 we took all of the available market information data,
2 liquidity elements, the uniqueness and structure of the
3 product to come up with the levels that we chose.

4 Some of those that we came out with, the
5 commission may recall, we got a resounding response
6 from the marketplace that they were unusable. And this
7 was particularly in the power segment. And when you go
8 into power and you look at the complexity of how that
9 power market is calculated, it resonates with you to
10 understand why you have to have a much lower level,
11 bases how that market trades and is priced.

12 So it is not a one-size-fits-all equation,
13 you know, I assure you. And it's something that needs
14 to take very much into consideration the risks
15 associated with every one of those products in the
16 market that you're trying to serve.

17 What's been very beneficial by all of this is
18 the greater transparency behind the establishment of
19 these block transactions, the reporting information and
20 the ability now to be building up more historical data
21 for us to benchmark and base our calibrations off going
22 forward.

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1 MR. HIRANI: Would it be possible to add
2 something to that?

3 MR. SHILTS: Yeah, just if maybe one more.
4 And I don't know if -- Commissioner O'Malia, are we --
5 do you have any questions? But, yeah, maybe this will
6 be about it because we want to try to end this fairly
7 soon. Because for our fourth panel, you know, some
8 people have to leave and they may not be able to sit
9 through the whole thing. So maybe just maybe one more
10 comment and maybe one question. And then --

11 MR. HIRANI: Sure.

12 MR. SHILTS: -- we'll wrap it up.

13 MR. HIRANI: I very much agree with what
14 Jerry and Bryan said. What you're hearing them say is
15 the energy market is very complex and there's certain
16 instruments that are very, very liquid, deep
17 transparent that trade on a CLOB. But what they're
18 also saying is that there's thousands of other
19 instruments that are illiquid that don't lend
20 themselves to a CLOB that require a lower block
21 threshold.

22 And that's exactly the analysis and the

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1 thought process that I would encourage you to look at
2 for the interest rate swaps market. Because you have
3 2s, 5s, 10s, 30s that are very, very liquid that, I
4 believe, are futures-like that should be traded on a
5 DCM, on a CLOB.

6 But for all those other instruments, that
7 Vanguard and other asset managers all over the world,
8 including hedge funds, will be doing, allow those
9 instruments to be traded exactly using the same
10 analysis that Jerry and Bryan have outlined, to trade
11 them using a block size -- a lower block size than you
12 would for 2s, 5s, 10s, 30s, and allow those instruments
13 to be traded -- exchanged for physical and exchanged
14 for risk. Thank you.

15 MR. PULLEN: Rick, can I follow up with that?
16 I had a question on that. So in follow-up -- and I've
17 heard many comments along this same ilk, but I've heard
18 no consideration of portfolio of risk, except by Mr.
19 Thum from Vanguard, where he talked about his hedging
20 of the risk on a portfolio basis.

21 But liquidity providers are also looking at
22 risk in that same way. Whether those are liquidity

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1 providers on your exchanges or on your future SEFs,
2 they're providing that liquidity based on a portfolio.
3 So I have a hard time following the logic that a two-
4 year and a two-year two-day should have different block
5 sizes. If everyone would like to elaborate, that'd be
6 great.

7 MR. CAWLEY: Yeah, let me see if I can help
8 elaborate on that. The notion of parsing, certainly in
9 the interest rate swap markets, the liquid points on a
10 curve, 2s, 3s, 5s, 7s, 10s and so forth, what happens
11 then when you take exactly a five-year, which is highly
12 liquid and no one disputes to trade in block and
13 whether trade on the central limit order books or what
14 not, it's -- we all agree that it's more liquid than,
15 say, a four- and-a-half year.

16 But then what happens with that swap is it
17 rolls down the curve and it's no longer a five-year.
18 What do you do with it then? So you're right George;
19 you have to look directly at what market practitioners
20 in the interest rates market do today and that is when
21 -- you know, I get hit with 7.2-year swaps, I'm looking
22 -- I'm going to look -- going to hedge that with a

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1 basket of 7s and 10s. I'm going to take my two most
2 liquid points around that swap and hedge it.

3 So -- and if I'm going to do that, I should
4 really consider -- or you should really consider -- or
5 it should be considered the liquidity of both the 7-
6 year and the 10-year swap around it. So don't only
7 just consider the liquidity in the particular widget.
8 Again, interest rate swaps -- and I'm not an expert on
9 energy. But I'll tell you, interest rate swaps are
10 traded on a portfolio basis.

11 We don't go out and hedge individual swaps
12 piecemeal. It would be inefficient and impractical. So
13 again, when you get hit with something between liquid
14 curve points, you have to consider the -- if you're
15 going to hedge using liquid curve points, you should
16 consider the liquidity of those curve points than in
17 your block trade threshold.

18 And, you know, one further just point on
19 that. If I take two-year swaps or one-and-a-half-year
20 swaps and hedge it with a Eurodollar strip, well, then
21 shouldn't I also consider the liquidity in the strips -
22 - in the Eurodollar market and -- as part of that

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1 calculation as well?

2 So, you know, the idea here is on one side
3 you want to promote transparency. And I agree with Don
4 in terms of, you know, you want to properly -- you want
5 to have a -- you know, an orderly functioning market.
6 And you don't want to penalize guys who want to make
7 large markets. But also, you want to incentivize
8 transparency within limit order books to the extent
9 that you can.

10 So I would argue that -- exactly what you
11 just alluded to, which is consider it on the portfolio
12 basis.

13 MR. SHILTS: Any more comments about that?

14 MR. SRINIVASAN: Can I ask one question?

15 MR. SHILTS: Sure.

16 MR. SRINIVASAN: Thank you. So, you know, we
17 were looking at the data for the energy complex. And
18 there have been comments that we should be looking at
19 the liquidity of the contracts to figure out the block
20 thresholds. And we see that there are contracts which
21 trade -- so in all over 10,000 contracts a day at
22 least. It's a large number of contracts, which are

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1 pretty liquid.

2 But we do see that the majority of the
3 trading activity of these energy contracts happening
4 through blocks. So -- and earlier they were
5 EFSs; now, it's happening through blocks. So
6 the question is, you know, the futures industry, the
7 same as it always has been, if you're doing over 5000
8 contracts a day, then it's a liquid market.

9 So we are -- we do see the data. There are a
10 decent number of contracts -- energy contracts which
11 are doing over 5000 contracts a day. But -- so the
12 majority of the trading activity is happening through
13 the blocks. And the block size -- and if you compare
14 those with equal and non-energy contracts with similar
15 volumes, those non- energy contracts have a much larger
16 minimum block thresholds. It can be, like, 200
17 contracts for a non- energy contract. But for that
18 energy contract, it would be 25 contracts or 5 or even
19 1.

20 So we're just trying to figure out, you know,
21 how do we make sense? So we're looking at the
22 liquidity, going by, you know -- if you just look at

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1 what's being printed on the exchange, it seems liquid,
2 right? But if you looked at the block thresholds,
3 they're really high. The block thresholds are low and
4 the block activity is pretty high.

5 So, you know, what are we doing? Do we look
6 at different sectors differently or do we just say --
7 go by the trading activity and say, "Okay. This is a
8 liquid contract and this should be treated like any
9 other liquid futures contract?"

10 MR. FARLEY: I'll just make a couple of quick
11 comments, Bryan. The conversation, at least in ICE's
12 case, from swaps to futures, we view it as a fairly
13 fundamental event. And, you know, our kind of internal
14 mantra was a version of the Hippocratic Oath, "Do no
15 harm." And the market largely is traded as you
16 described.

17 So in the -- whatever particular contract
18 you're describing, 10,000 a day that does some high
19 percentage of blocks, that's how it -- that market had
20 evolved. And on ICE, we had always made a central
21 limit order book available to customers alongside block
22 trade -- block trading. And the market, for whatever

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1 reason, in that particular case had evolved in that
2 way.

3 So as part of the conversion, our goal was to
4 do no harm and provide the ability both the Friday
5 prior to our conversation, as well as that Monday
6 morning when we were a futures for the market to
7 continue to behave as it always has. I would give it
8 some time. This was just October.

9 MR. SHILTS: Right.

10 MR. FARLEY: These markets are now futures.
11 My sense is that they will evolve. You probably will
12 see more central limit order book trading. And I think
13 it's probably a more interesting intellectual or
14 academic conversation six months from now or a year
15 from now, once the -- you know, that these markets as
16 futures have had a chance to mature.

17 MR. JESKE: I would add to that comment,
18 certainly from a user's perspective, what you're
19 talking about is electronic screen-based trading versus
20 voice broker trading. And I think, as Bill mentioned,
21 you've got the broker community out there that's trying
22 to provide that liquidity. Call it an EFS. Call it a

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1 block. It's irrelevant.

2 Those transactions have grown up in the voice
3 broker community. You can't flip a switch overnight
4 and make it different. You can't make people behind
5 their desks start trading on a screen immediately.
6 That's -- the point Tom made about give there some time
7 is absolutely correct. People aren't going to change
8 their customer practice overnight.

9 The change between EFS and block has been a
10 very constructive one because it's streamlined. You
11 don't have two swaps anymore. You have one
12 transaction. It's a lot less clunky. The market likes
13 it. It works. As it relates to the broker community,
14 if everything's forced into a central limit order book,
15 you're forcing the brokers out of business to a large
16 extent. And I don't think that's good for anybody.

17 Certainly in the physical world, you have to
18 have brokers communicating. Again, there's not enough
19 counterparties out there. And, you know, we strongly
20 believe that the commission should do nothing to chase
21 away counterparties in a nutshell.

22 MR. THUM: If I could just --

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1 MR. SHILTS: All right. Yeah, maybe one last
2 comment. Because we don't want to lose our panelists
3 for the next panel.

4 MR. THUM: Sure. Real -- just real quick. In
5 our letter from May, we quoted a study from ISDA that
6 showed the average daily trading volume for all
7 interest rates derivatives is 6800 trades, of which
8 2500 are new price-forming trades. The most popular,
9 the US dollar ten-year swap, trades on average of 200
10 times a day.

11 So while the breadth of the market is huge,
12 the depth of the market is actually pretty shallow. So
13 when you think about the current proposal, which has
14 extremely large block sizes in the proposal, it's
15 really out of whack, given the actual liquidity that's
16 presented by these products. So if those proposals
17 continue on, it will really disrupt the available
18 liquidity, the products and certainly the price that
19 we, as users, get for trading those products, given the
20 depth is so small.

21 MR. SHILTS: Well, thank you all for your
22 participation on the panel. It's -- I think we'll

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1 take, like, a five-minute break. Maybe at 3:10 we'll
2 start back. Thank you.

3 (WHEREUPON, the meeting went off record from
4 3:02 p.m. to 3:10 p.m.)

5 MR. SHILTS: If everyone wants to take their
6 seats so we can get started on the last panel? Thank
7 you.

8 MS. GUTMAN: Thank you all for being here.
9 I'm sorry it's running a little late. Panel 4 will
10 focus on the effect of the conversion of swaps to
11 futures on end users specifically and any issues or
12 changes regarding consistency between swaps and futures
13 regulations to existing regulations or to future Dodd-
14 Frank rulemakings to address these effects.

15 Please elaborate on how this affects your
16 trading and hedging strategies as end users in deciding
17 whether to use swaps or futures. Before we begin this
18 discussion, I'd like to go around the table and have
19 everyone introduce themselves and identify who they
20 represent.

21 MR. ALLISON: I'm Jim Allison. I'm the
22 global risk manager for ConocoPhillips.

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1 MR. REYL: Charles Reyl, CEO, Parity Energy.

2 MS. INGBERG: Sally Ingberg. I work at
3 Forest City Enterprises, a real estate company.

4 MR. CAMPBELL: Lael Campbell, Exelon, where
5 I'm responsible for the energy trading compliance
6 program.

7 MR. DEAS: I'm Tom Deas, vice president and
8 treasurer of FMC Corporation. And I'm chairman of the
9 National Association of Corporate Treasurers.

10 MR. KOTSCHWAR: I'm Lance Kotschwar with
11 Gavilon here on behalf of the Commodity Markets
12 Council.

13 MR. ZUBROD: Luke Zubrod with Chatham
14 Financial, a risk management advisory firm.

15 MR. FRENK: David Frenk, the research
16 director of Better Markets.

17 MR. CAMPBELL: I'm Paul Campbell with
18 Deloitte and run our energy regulator and risk
19 practice. I'm not representing any clients here. I'm
20 just on behalf of Deloitte.

21 MS. GUTMAN: Okay. Thank you. To quickly
22 review the format, we will have each panelist provide

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1 their prepared remarks for four minutes or less. Once
2 we hear the panelists' prepared remarks, we will then
3 start an open discussion. So that we can hear from
4 everyone, please hold your follow-up comments until
5 either your remarks or until after all panelists have
6 had the opportunity to make their prepared remarks.

7 And we will start with you, Jim Allison.

8 MR. ALLISON: Thank you. And I appreciate
9 the opportunity to be here for this roundtable to
10 discuss these implementation issues. As I said, I'm
11 Jim Allison. I'm the manager of global risk for
12 ConocoPhillips. ConocoPhillips is the largest North
13 American-based, independent exploration and production
14 company, based on production and reserves.

15 We're headquartered in Houston, Texas. We
16 have operations and activities in 30 countries and
17 about 17,000 employees. Because we're a producer of
18 crude oil and natural gas, we're also a marketer of
19 those vital energy commodities. And we use energy
20 derivatives in connection with those marketing
21 activities.

22 Derivatives, both futures and swaps, are

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1 tools, not ends of themselves. For these to work well,
2 two things must be true. The tool must be well suited
3 to the task and we have to know how to use the tool.
4 From that perspective, the futurization of swaps is a
5 good thing mostly. I'll come to my caveat at the end
6 of the presentation.

7 For transactions that are standardized and
8 appropriately cleared, futures are well suited to the
9 task. The development of cleared swaps over the last
10 decade was a useful innovation at the time but the
11 distinction between a cleared swap and a future may no
12 longer be useful. Preserving a distinction that is not
13 useful adds unnecessary complexity for market
14 participants and for regulators. In short, it appears
15 to me that cleared swaps is now a redundant distinction
16 in the marketplace.

17 Futures do what we need those transactions to
18 do. Futures markets have evolved to facilitate the
19 breadth of transactions we need. Therefore, it's
20 important that futures regulation continue to evolve
21 with the markets to continue to enhance the efficiency
22 of the markets, which was, of course, one of the

1 original goals of Dodd-Frank.

2

3

4

5 One particular way in which regulation should
6 evolve is with respect to how these positions get
7 created. I'm referring here to block transactions,
8 which has been the topic of much discussion in the
9 previous panels. So let me just echo a few of the
10 themes that resonated with me from the previous
11 discussion.

12 Much of the liquidity in the energy
13 derivatives is now on the electronic platforms and that
14 creates much better transparency than anybody could
15 ever have imagined in the days of the trading pits. But
16 the trades that are blocked in are still an important
17 supplement to those.

18 From our perspective, the DCMs ought to
19 retain the flexibility to manage the block limits, as
20 we heard discussed in the previous panel. Block size
21 should be related to liquidity, with lower liquidity,
22 meaning lower thresholds for block sizes. So to the

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1 previous question of how big is a block, big should be
2 judged in my view relative to the trading activity in
3 that particular instrument.

4 And as was noted, we are evolving from a
5 previous world into this world of a pure futures
6 transaction. We're not fully evolved in that space
7 yet. So you see some things in the data that may not
8 look completely normal to you. But the evolution is
9 continuing.

10 We also need to recognize the role that the
11 voice brokers or other facilitators have played in the
12 market. They play an important role in the physical
13 market. They have played a role in the EFS market and
14 now in the block market. And in particular, they also
15 play a role in the market for bespoke swaps. So
16 whatever it is we do from a regulatory perspective, we
17 need to preserve the role of those facilitators, such
18 as the voice brokers.

19 We've also heard a lot of discussion about
20 the need for a level playing field, setting aside Mr.
21 Parson's concerns about how level is level. From my
22 perspective, if we accept that futures and cleared

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1 swaps are functionally equivalent, that the category we
2 call cleared swaps is, in that sense, redundant, then
3 there is no potential for regulatory arbitrage because
4 there is only a single regulatory structure appropriate
5 -- that is the structure for futures.

6 All in all, so far as cleared swaps are
7 concerned, my complaint is that futurization may not
8 yet have gone far enough -- again, specifically these
9 concerns about block sizes. But as I said, there is a
10 maybe. There are other swaps to consider. While I'm
11 comfortable regarding cleared swaps as futures, we must
12 also assure that the market deals properly with
13 transactions that are not appropriate for clearing.

14 There are at least two reasons why a swap
15 would not be appropriate for clearing. First, the swap
16 might be bespoke, so that it doesn't fit easily into
17 the clearing framework. Second, the swap might be a
18 hedge and clearing might have the perverse effect of
19 increasing the risk the hedge was intended to reduce.
20 The case of bespoke swaps has, I think, been adequately
21 covered. The impact of clearing on the performance of
22 hedge perhaps has not.

1 There was discussion earlier that risk
2 doesn't go away; it is simply transformed. This is an
3 example of clearing transforming counterparty risk into
4 liquidity risk. So the issue arises because clearing
5 requires daily margining. As a result of the
6 margining, the daily and monthly cash flows from the
7 derivative are very different from the cash flows
8 generated by the asset hedge.

9 An entity that was hedging for the purpose of
10 smoothing cash flow would discover that clearing would
11 result in cash flow that was more volatile than it
12 would have been without the hedge. So it is essential
13 that hedges be exempted from the clearing mandates. And
14 of course, the statute does that.

15 My concern then is to assure that the trend
16 toward futurization does not drive these transaction
17 types, which must remain swaps, out of the market.
18 These non-cleared swaps may require more bilateral
19 discussion before a transaction can be consummated,
20 either to customize terms or to arrange credit support
21 other than clearing. Electronic transaction platforms
22 by themselves do not handle that sort of negotiation

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1 well.

2 In the current state, voice brokers play an
3 important role in bringing the ultimate counterparties
4 together. And it's important that role continue.
5 Fortunately, if, as I was recommending earlier, the
6 regulations continue to allow easy access to block
7 futures, I'd expect that activity to help assure the
8 continued role of the voice brokers.

9 Thank you and I'll answer questions later.

10 MR. REYL: Thank you very much for the
11 opportunity to participate in this roundtable. I am
12 Charles Reyl, CEO of Parity Energy. We are an exempt
13 commercial market and a broker for commodities. My
14 goal today is to share with you my experience on the
15 ground in the energy markets, more specifically, the
16 energy options markets, which have been directly
17 impacted by the futures to swaps transition.

18 In 2008, Parity Energy launched the Parity
19 Energy Platform, or PEP, as an exempt commercial market
20 for cleared energy options. And right from the start,
21 PEP incorporated many of the futures that a proposed
22 SEF rule would later require of swap execution

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1 facilities.

2 Since 2008, Parity has offered many -- to
3 many an electronic order book, firm bids and offers,
4 requests for quotes, pre- and post-trade transparency,
5 as well as a very robust voice brokerage service. Now,
6 over, you know, 175 institutions have access to PEP,
7 including end users, energy producers and marketers,
8 banks and hedge funds. These institutions have come to
9 rely on Parity for price discovery and trade execution
10 services.

11 Now, prior to the swaps to futures
12 transition, Parity was on track to become a SEF. And
13 given the overwhelming rejection of swaps by the energy
14 trading community, we now don't see the point anymore.
15 Whether to apply for SEF status or not will depend on
16 the final rules for DCM Core Principle 9, minimum block
17 thresholds and SEFs.

18 So before October 14, 2012, energy swaps
19 included everything that did not trade on a central
20 limit order book or open outcry. So most of this
21 market traded through inter-dealer voice brokers. So
22 again, for instance, in energy options, swaps

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1 represented about 80 percent of the overall trading
2 volume -- so in terms of volume.

3 So since then, all market participants -- or
4 nearly all market participants have moved from swaps to
5 futures. And I think, as Tom Farley of ICE earlier
6 mentioned, customers just love it. And rather than
7 migrating to central limit order books, most of these
8 energy swaps continue to be negotiated off exchange,
9 through voice brokers before being posted as futures
10 blocks.

11 So I think this is important because what it
12 means is that customers did not switch to -- because of
13 greater liquidity or convenience, but mainly because
14 they wanted to avoid stiffer swap regulations. So by
15 definition, off exchange trading activity on the DCM
16 should be the exception rather than the norm. But any
17 effort to address this issue in the absence of a
18 strong, viable swaps alternative is likely to cause the
19 market to die from lack of liquidity information.

20 And this would severely hurt end users and
21 any other market participants who rely on such
22 derivatives for their risk management. So for Parity

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1 specifically, the futurization of the energy markets
2 has reduced the value proposition of its electronic
3 services. So Parity now functions through its futures
4 entity in order to broker block trading of futures
5 contracts on various DCMs.

6 Because those DCMs prohibit the use of
7 transparent, electronic off exchange matching, PEP now
8 functions as a white board, showing only indications of
9 interest. So all transactions we facilitate today must
10 be consummated by voice and with help from the market
11 until they are reported to the DCM. This is a step
12 backward compared with Parity's original transparent
13 electronic matching as an ECM.

14 Namely before the futurization, over-the-
15 counter derivatives were electronically traded on PEP
16 with full pre- and post-trade transparency for all
17 participants. And now, ironically, after the
18 futurization, all trades are exclusively voice brokered
19 and the real time transparency Parity used to offer is
20 prohibited.

21 So as a result, I respectfully ask the
22 Commission to determine whether it is in the interest

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1 of end users and other market participants for DCMs to
2 have rules which prevent the facilitation of block
3 trades on a system that's accessible to multiple
4 participants and that allows for electronic matching.

5 Also, I think we should really make swaps a
6 genuine alternative to futures blocks. And if the
7 commission regulates end users who trade swaps and swap
8 dealers more strictly than any futures market
9 participant, then maybe it should make swaps more
10 flexible in return, which I think is the idea.

11 For instance, in terms of, you know, minimum
12 block size or by allowing a variety of trade execution
13 mechanisms for swaps, including the RFQ, auction,
14 voice, as long as appropriate minimum levels of pre-
15 trade transparency are achieved.

16 But in any case, we feel that the minimum
17 block thresholds for futures should not be raised until
18 either central limit order book trading takes off or a
19 viable swaps alternative is made available.

20 On behalf of Parity, I thank you very much
21 for the opportunity to share our thoughts and I look
22 forward to answering any questions.

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1 MS. INGBERG: Hi. Thank you for allowing me
2 to speak today about the futurization of swaps. My
3 name is Sally Ingberg and I'm vice president of debt
4 management at Forest City Enterprises, which is a
5 national real estate company headquartered in
6 Cleveland, Ohio.

7 One of my main responsibilities is to
8 coordinate our derivative risk management strategies on
9 behalf of the company. These derivatives are simply
10 used to mitigate interest rate risk on our mortgage and
11 corporate debt financings. This is done to minimize
12 our -- the exposure to our largest single expense,
13 interest expense.

14 Derivatives have been an extremely useful
15 tool for Forest City over the past 25 years. In the
16 over-the-counter market we're able to effectively
17 protect the cash flows of the property as over-the-
18 counter products allow for us to match the resets of
19 our loans.

20 Additionally, over-the-counter products
21 allowed for us to have notionals on the hedge match the
22 anticipated loan balance for the loan. This is

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1 especially important for real estate companies because
2 our construction deals normally accrete while our
3 stabilized properties normally have amortization.

4 Last, of upmost importance, many times the
5 collateral on the derivative in the over-the-counter
6 market is secured by the property rather than cash.
7 Because the only cash flow on the property are rental
8 income streams, which is received over time, we do not
9 have excess cash available at any point in time to sit
10 in margin accounts.

11 In the event the borrower ceases to be able
12 to - - be able to make its payments on the loan, the
13 lender would be able to recoup its losses on both the
14 loan and the swap through the value of the property. To
15 the extent the building value had diminished so
16 substantially that it ceases to be able to cover the
17 lender's losses on the loan and swap, the lender's
18 losses would be no more than the losses that they would
19 have incurred on a comparable fixed rate financing.

20 How do we ensure that we get the most
21 efficient pricing in the over-the-counter markets? Many
22 times, in order to get the best price and maintain

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1 transparency, we conduct competitive auctions amongst a
2 group of swap dealer counterparties who are all
3 important bank relationships. This is important to
4 note because we look at the overall cost of our capital
5 and the overall lending liquidity -- lender liquidity
6 pool of which derivatives are only one component.

7 To avoid surprises after the trade is
8 completed, both parties agree on key transaction terms
9 pre-trade using pre-trade transaction term sheets.
10 However, actual trade documentation is not completed
11 until post-trade and only with the winning bank, a
12 sequence that maximizes bank participation in auctions
13 by minimizing the pre-trade documentation burden.

14 While many Dodd-Frank rules have yet to take
15 effect, I would be remiss if I didn't point out that
16 certain documentation rules that have been discussed
17 could discourage competition in transparency by
18 increasing the burden of participation for bidding
19 banks. Anticipatory compliance with such rules has
20 resulted in higher costs to us and, in some cases, has
21 created difficulty in finding counterparties willing to
22 trade with us, problems we anticipate will increase

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1 once swap documentation rules become effective.

2 Given the situation, many of you might
3 suggest that we simply move into the futures market
4 since the market is more transparent and
5 straightforward. However, given the nature of our
6 business, our derivatives available in the future
7 market would not fit in with the structure of our
8 financings, creating basis risk, accounting problems
9 and liquidity issues.

10 There are four main reasons for this. First,
11 the inability to use property as capital on exchanges.
12 For the vast majority of our interest rate swaps, the
13 swap is secured by the real estate, just as the loan
14 is. Exchanges cannot accommodate real estate assets as
15 collateral. And, most importantly, our lenders have
16 requirements within their documents that we are not
17 allowed to have any other kind of subordinated
18 financing, such as posting cash, taking any --
19 something out of, you know, the lender's ability to get
20 their money back on the -- their swap and the real
21 estate, should something happen to either.

22 Second, futures require initial margins,

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1 something we do not post today. Assuming there was a 3
2 percent initial margin requirement in lieu of the
3 structure that exists today and has been grandfathered
4 in by using real estate, this could have resulted in
5 collateral posting of \$48 million as of our most recent
6 quarter of hedges that were outstanding.

7 Third, exchanges in central clearing require
8 variation margins. As of our most recent quarter end,
9 if all of our swaps were -- sorry -- required to post
10 cash, it would have resulted of us posting an
11 additional \$180 million, which would bring the total
12 amount of cash required to be posted to be almost \$230
13 million. This would have been an extraordinary use of
14 our cash, since as of last quarter, we only had \$214
15 million available on our credit facilities that is used
16 to fund the entire operations of the company.

17 To be clear, as a real estate company, our
18 core area of business is the management, ownership,
19 development of real estate. Hedges are not the main
20 component. And therefore, we can't have our cash
21 availability potentially tied to a non-core need.

22 Last, the futures markets do not accommodate

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1 the customization needs required to perfectly address
2 our risks. So taking these factors into consideration,
3 the question is, whether the over-the-counter markets
4 are no longer cost effective or if there are not enough
5 counterparties who are willing to participate, will a
6 company like Forest City end up leaving the over-the-
7 counter market and move into the futures market?

8 This is unlikely for the reasons that I've
9 cited today. What this ultimately means for a borrower
10 like Forest City is to go into higher cost fixed-rate
11 financing or leave our floating rate debt unhedged.
12 This results in a loss of transparency, loss of
13 flexibility and increased risk to non-financial end
14 users like us.

15 I, therefore, urge you to take into account
16 the need of end users when designing requirements like
17 capital and margin requirements that could -- that
18 could already adversely affect and impact our end user
19 ability to utilize the over-the-counter derivative
20 market.

21 I thank you again for allowing me to speak on
22 behalf of non-financial end users who are simply using

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1 derivatives to mitigate fluctuations to risk.

2 MR. CAMPBELL: Well, thank you. And I want
3 to thank the Commission for the opportunity to be here
4 today to discuss this important topic that impacts
5 energy markets and energy companies like Exelon. Exelon
6 is one of the leading companies in the physical
7 commodities space. Exelon is the number one
8 competitive power generator in the nation and owns
9 nearly 35,000 megawatts of generation assets.

10 Exelon, through its Constellation brand,
11 serves physical commodity needs of approximately
12 100,000 business and public sector companies and
13 customers, including two-thirds of the Fortune 100.
14 Exelon also serves approximately one million
15 residential customers, their electricity and natural
16 gas needs.

17 As an end user, Exelon actively participates
18 in the futures and swaps markets to hedge and manage
19 risks related to this physical portfolio. The
20 substantial majority of the company's hedging activity
21 is conducted in cleared markets, in particular, on ICE
22 and on NYMEX and often originated through voice

1 brokers.

2 Prior to 2012, these hedging activities were
3 mostly in swaps. But starting with the ICE transition
4 in October, these hedging activities are now conducted
5 mostly in futures. The switch to futures has been
6 relatively seamless from Exelon's standpoint as an end
7 user. For the most part, little has changed in day-to-
8 day hedging operations.

9 The transition to futures, however, has had
10 one material insignificant impact on our business and
11 that is in the area of compliance. Exelon is committed
12 to having a reputation for excellence in compliance and
13 compliance is a critical component of every business
14 decision the company makes.

15 In the energy sector, and in particular, in
16 the context of Dodd-Frank, many of the standards for
17 compliance are subjective, qualitative and oftentimes
18 confusing. However, the transition to futures has
19 provided a refreshing source of compliance clarity.
20 Rules relating to futures are mature. They're well
21 understood and developed and, therefore, present
22 minimal incremental hurdles to navigate.

1 This clarity is invaluable to those
2 transacting in the market, for company leadership
3 trying to make long-term decisions and for people like
4 me, who are responsible for providing legal and
5 regulatory advice to these stakeholders.

6 Furthermore, the benefit of compliance
7 clarity that futurization brings has come with minimal
8 costs to energy market participants, while also
9 satisfying many of the key goals of financial reform.
10 Futures markets have longstanding and robust oversight
11 by this Commission. Futures markets are centrally
12 cleared.

13 And from a transparency standpoint, including
14 pre-trade transparency, and in particular with energy
15 markets, where -- and power markets in particular,
16 where many products are thinly-traded, futures markets
17 arguably provide more and certainly not less
18 transparency than if they were transacted as swaps.

19 Liquidity is the key element to transparency.
20 And one needs to ask, at least from the context of
21 energy markets, many of which are thinly traded,
22 whether futurization has broken anything that needs to

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1 be fixed. It is difficult to regulate liquidity into a
2 market but it is very easy for regulation to take
3 liquidity out of the market. Thank you.

4 MR. DEAS: Thank you. I am Tom Deas, Vice
5 President and Treasurer of FMC Corporation. We are a
6 global chemical company. We are on the ground in two
7 dozen countries making and producing a broad range of
8 agricultural specialty and industrial chemicals.

9 One of those product lines is soda ash, the
10 principal ingredient in glass manufacturing -- and for
11 other uses. We are the world's largest producer of
12 natural soda ash, and we'd like to think we're a real
13 export success story. We operate in Southwestern
14 Wyoming where we are one of that state's largest
15 employers.

16 We can make soda ash, ship it to South Asia,
17 and bump Chinese synthetically produced product back
18 into China with a higher quality and lower cost
19 product.

20 We do this in part because of our ability to
21 predict and control our cost, and to do that at this
22 facility in Southwestern Wyoming, we use flexible,

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1 over-the-counter derivatives to hedge natural gas
2 exposure.

3 We do not use futures contracts, and I'll
4 describe in a minute the advantages we see from over-
5 the-counter derivative use and how we'd like the
6 commission to continue advocacy of that as an
7 alternative that's available to end users like FMC.

8 We use calendar year strips to hedge our
9 natural gas exposure. We are going out two years, and
10 sometimes farther. We average in -- not trying to time
11 or guess the market -- but by layering in a series of
12 calendar year strips for the future on a periodic
13 basis.

14 We are able to do this between the underlying
15 exposure on the main index and with basis swaps, with a
16 few dozen over-the-counter derivative trades. They are
17 all done under ISDA master agreements with one of the
18 syndicates of banks that are also providing us in total
19 with a billion and a half dollars of committed credit.
20 And there is a legal right of offset that helps us
21 manage the credit exposure that we have on the
22 derivative trade with the amounts that we've borrowed

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1 from these banks under this credit agreement.

2 We're an "A" rated company. We have no
3 credit support annex or other commitment requirement to
4 pay margin. We are doing uncleared, over-the-counter
5 derivatives, just like we always did, and we hope we
6 are going to do those in the future.

7 We support the Commission's interpretation of
8 the margining requirement under Dodd-Frank and we would
9 absolutely urge you to continue your efforts to resolve
10 this big uncertainty for end users with the prudential
11 regulators and try to assure that we can continue to
12 use this flexible product to manage our costs.

13 One of the advantages we get from using over-
14 the-counter derivatives is that the futures market --
15 because of the way transactions need to be stacked in
16 that market instead of being negotiated on a strip
17 basis with an over-the-counter derivative -- would
18 cause us to enter into at least 12 times more
19 transactions to hedge a year's exposure.

20 Moreover, because of the margining
21 requirement under a futures contract, we'd have, let's
22 say, another 250 transactions. When you multiply that

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1 transaction flow out you get -- here's numbers to
2 contrast -- in over-the-counter derivatives, we can
3 complete the hedging program through the execution of
4 about 100 transactions, and with the futures
5 equivalent, it would be 144,000 transactions.

6 And so, as an end user, not involved in the
7 energy space, other than to hedge this component of our
8 input costs, of our productions costs -- we are not
9 operating a trading room, and we don't have the back
10 room facilities to be able to handle that huge -- more
11 than a thousand fold increase in the transaction volume
12 that a move to the futures market would require of us.

13 So, just to summarize, over-the-counter
14 derivatives for us provide significantly lower
15 transaction intensity than the futures equivalent.
16 There is much greater liquidity by trading an entire
17 calendar year strip for us than the futures alternative
18 in some months that may be out at the end of time
19 horizon of our hedging program.

20 We have a much greater ability with over-the-
21 counter derivatives to make adjustments. One of the
22 reasons that the over-the-counter derivatives market

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1 grew to be the largest financial market in the world
2 was its ability to customize and allow end users like
3 us exactly to match the underlying exposure with a
4 derivative attuned to that exposure in terms of amount,
5 currency, tenure -- all of the other components -- and
6 that's not available to us in all instances in the
7 sometimes one size fits all futures market.

8 So, again, I would just appreciate the
9 Commission's effort to do everything you can to
10 maintain over-the-counter derivatives as a viable
11 alternative, not to burden them with margin
12 requirements or other impediments that would take this
13 alternative away from us.

14 Thank you.

15 MR. KOTSCHWAR: Good afternoon. I'm Lance
16 Kotschwar with Gavilon. I'm here on behalf of the
17 Commodity Markets Council. Thank you for the
18 opportunity.

19 I want to specifically address the two
20 questions that you had us consider today, Abigail, but
21 before I do that I wanted to just talk a little
22 generally about Dodd- Frank.

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1 We agree with the primary goals of Dodd-
2 Frank, which is to reduce the systemic risks through
3 centralized clearing, increasing transparency through
4 reporting and trading unregulated platforms where
5 applicable.

6 And we also agree with Congress that futures
7 and swaps should be regulated appropriately and that
8 regulation for swaps should be different than futures
9 because they are different things.

10 Not all swaps must be traded on exchanges or
11 cleared, because commercial should be able to enter
12 into swaps but not futures, over-the-counter, as they
13 do today to hedge risks.

14 As commercial end users and other market
15 participants, we need the most efficient and
16 effective markets to manage our risks, including
17 both listed futures and over-the-counter products. Our
18 businesses depend on the price discovery and the
19 liquidity of futures markets, and we also rely on the
20 ability to use customized swaps as well.

21 So we don't think it's quite accurate to say
22 that there's disparate regulatory treatment between

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1 futures over swaps. We think there are underlying
2 reasons for that that are legitimate and make sense.

3 Many of the new swap regulations are similar
4 to the regulations that have historically been imposed
5 on futures markets, but they also reflect key
6 differences and two primary factors drive that, I
7 think.

8 There are different risk characteristics
9 between futures and swaps, and then there is just a
10 different trading manner. Futures traditionally are
11 standardized. They trade centrally on DCM's. Swaps
12 have historically been more customized and traded
13 bilaterally in over-the-counter dealer markets.

14 The margin requirements for futures and swaps
15 are another example of traditional expectation
16 regarding the relative standardization of products held
17 in futures portfolios versus the more customized nature
18 of products held in swap portfolios.

19 And also, another example is flexibility and
20 execution afforded to swaps via SEFs versus
21 customized products because they don't lend themselves
22 well to trading in centralized markets.

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1 As market participants, we will continue to
2 consider whether a customized or standard product will
3 serve our needs best. Regulatory treatment of futures
4 versus swaps will be a part of that calculation, and
5 the fact that firms are making these trading decisions
6 based on this kind of assessment does not mean that
7 swap markets have been unfairly disadvantaged. We will
8 continue to use them both to serve our risk management
9 needs the best way we can. Innovation and competition
10 and customer choice among well regulated markets is
11 important to us.

12 I want to get specifically to the two
13 questions that we were directed to today. Question #1:
14 "In light of ICE's and CME's listing of energy swap
15 contracts as futures contracts, which coincided with
16 the October 20, '12 effective date of the swaps rules,
17 what issues or challenges would you like to bring to
18 the attention of the Commission?"

19 We do not have any issues or challenges we
20 would like to bring to your attention other than to say
21 that we appreciate the Exchange's responsiveness to the
22 requests of their customers.

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1 We would, however, like to make an
2 observation that from our perspective the big driver of
3 what ICE and CME did in October was really the result
4 of one thing, regulatory certainty, something that Lael
5 said earlier.

6 On October 12th, many Dodd-Frank rules began
7 to go into effect. The problem is that there was then,
8 and still remains, a tremendous amount of uncertainty
9 around the swap regulation regime. And futures
10 regulation is something we all are familiar with and
11 comfortable with, and certainly in the short term it
12 provides our compliance staff with significantly more
13 comfort. Again, that's something that Lael said.

14 The second question: "Are there any issues
15 or challenges that should be addressed regarding
16 consistency between swaps and futures regulations,
17 whether in one of the remaining rulemakings, or
18 something that has already been put out?"

19 As I've discussed, I think there are
20 legitimate reasons for treating swaps and futures
21 differently, owing to the differences between the
22 instruments. We believe that futures instruments have

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1 been, and are currently being regulated in an
2 appropriate manner.

3 However, with respect to the regulation of
4 swaps, I think it is a fair question to ask whether all
5 of the recently promulgated rules, and still pending
6 rules applicable to swaps and swap dealers, are
7 appropriate.

8 But just to wind up here, from our
9 perspective - - you know, the thesis of the derivative
10 title of Dodd- Frank was the appropriate regulation of
11 swaps, not regulatory parity between swaps and futures,
12 whatever parity means in that context.

13 And lastly, I know you tried to keep block
14 trading confined to one panel, but in keeping with
15 everybody wanting to throw in a gratuitous remark about
16 block trading, I just wanted to bring one more
17 perspective to it.

18 It's been said, but I just want to say it in
19 maybe a different way. You know, Dodd-Frank envisioned
20 a structure where swaps can trade across multiple
21 trading venues, unlike futures where a futures contract
22 is generally a proprietary to the exchange where it's

1 traded.

2 So with this distinction it makes some sense
3 that some entity other than the trading platform,
4 whether it's a SEF or a DCM, would aggregate the
5 liquidity of the instrument across trading venues and
6 set it in an appropriate block threshold. And there's
7 no individual trading venue that's going to have a full
8 view of all that liquidity.

9 But that is not how it works on the DCM
10 because you've got all of the liquidity right there in
11 one place, so we think in that sense it makes sense for
12 the DCM to continue to be able to evaluate and
13 determine block levels at that level. And again, in
14 keeping with my theme here, "if it ain't broke, don't
15 fix it," and it seems like the DCM approach to this is
16 working very well.

17 Thank you.

18 MR. ZUBROD: Good afternoon, and thank you
19 for the opportunity to offer an end user perspective on
20 futurization. My name is Luke Zubrod and I am Director
21 of Risk and Regulatory Advisory Services at Chatham
22 Financial. Having introduced Chatham on a prior panel,

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1 I will transition directly to my comments.

2 On the last panel I focused my comments on
3 concerns relevant to financial entity hedgers. On this
4 panel I'll focus on those concerns applicable to non-
5 financial end users.

6 The topic of futurization is an important one
7 for end users. End users specifically, and hedgers
8 more broadly, have long valued over-the-counter
9 derivatives because of the ability to customize them,
10 to perfectly mitigate a company's idiosyncratic risks,
11 and because of the ability to bilaterally negotiate
12 margin arrangements with swap dealer counterparties.

13 Regulatory actions that create an incentive
14 for end users to clear their trades or use futures
15 would have at least three adverse consequences, two of
16 which I mentioned on the prior panel.

17 Basis risk is one of those. Regulatory
18 incentives that encourage futures would cause companies
19 to take on basis risk, that is, mismatches between the
20 hedge and the risk that hedge is designed to address.

21 Basis risk poses a threat of loss for end
22 users, and that's especially true in times of market

1 stress.

2 Basis risk also leads to the second adverse
3 consequence, which is accounting and effectiveness.

4 Basis risk is reflected in financial statements as
5 accounting and effectiveness and because accounting and
6 effectiveness, and the income statement volatility it
7 creates, it's difficult or impossible to control.

8 Public companies often avoid hedging strategies that
9 might result in effectiveness.

10 The third issue -- and this is particularly
11 pertinent to non financial end users -- is liquidity
12 risk. End users appreciate uncleared, over-the-counter
13 derivatives, because they afford the ability to
14 transact in a manner that does not require the posting
15 of initial or variation margin.

16 Cleared swaps and futures trades, on the
17 other hand, are fully margined. Because margin
18 requirements create an unwelcome liquidity risk for end
19 users, many end users will accept higher costs on
20 uncleared, over-the-counter derivatives, in order to
21 avoid the liquidity burden created by fully margined
22 products.

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1 I would like to identify two areas in which
2 regulators can ensure its proposals do not adversely
3 impact end users by driving up costs or by introducing
4 new risks.

5 One, initial margin. Although non-financial
6 end users are not directly subject to initial margin
7 requirements in the CFTC's proposed margin rule, their
8 swap dealer counterparties are subject to such rules.
9 Because dealers typically offset their positions to end
10 users, the dealer must post initial margin on positions
11 used to offset end user hedges.

12 Because these initial margins are incurred
13 solely to facilitate the end users trades, the swap
14 dealer will increase the transaction price paid by the
15 end user to compensate it for what would otherwise be
16 an unproductive use of its funds.

17 The higher transaction price that results
18 creates a regulatory incentive for end users to
19 consider using futures, an incentive that brings with
20 it the aforementioned adverse consequences of basis
21 risk accounting and effectiveness and liquidity risk.

22 Capital requirements. Similar to initial

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1 margin requirements, capital requirements applicable to
2 swap dealers against trades executed with end users
3 will cause dealers to increase end user transaction
4 prices for uncleared swaps.

5 Higher pricing on uncleared swaps will create
6 regulatory incentives for end users to consider
7 clearing, even though they are technically eligible for
8 the end user exception.

9 Margin differences between cleared swaps and
10 futures will further cause end users to consider using
11 futures, however, because of countervailing business
12 incentives created by basis risk, accounting and
13 effectiveness and liquidity risk, many end users will
14 opt not to use cleared swaps and futures.

15 The net result for such end users will be
16 higher costs that could deter some users from hedging,
17 or make hedging more expensive.

18 Limiting or eliminating initial margin and
19 capital requirements applied to swap dealers when their
20 transactions are executed in connection with end user
21 hedging transactions would serve to lower end user
22 costs and avoid a deterrent to hedging. Regulators

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1 should consider such relief because end user hedging
2 activity does not meaningfully contribute to systemic
3 risk.

4 On this basis, Congress established an end
5 user exemption. Please don't take that exemption away
6 by making uncleared, over-the-counter derivatives, too
7 expensive to use.

8 Thank you.

9 MR. FRENK: Thanks. I'm David Frenk, the
10 Research Director at Better Markets. We are a
11 501(c)(3) nonprofit. I think you are all familiar with
12 us. We aim to represent the public interest in the
13 capital and commodity markets.

14 Most of us, myself included, used to work in
15 finance -- don't anymore -- which gives us the unique
16 opportunity to be on the one hand informed and on the
17 other hand impartial.

18 We appreciate the opportunity to come here
19 today and talk about futurization, although perhaps it
20 would be better titled, "Re-futurization," since for a
21 century or so, if you were an end users looking to
22 hedge, futures were your option.

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1 We had a brief experiment with the over-the-
2 counter markets. You could say a 30-year experiment,
3 or if you time it from CFMA, about an eight year
4 experiment, which was kind of a miserable failure given
5 that we nearly blew up the world, but then Congress
6 decided to go back to the drawing board and see if we
7 could sort of capture the best of both worlds.

8 They said, "Well, should we throw out OTC
9 swaps entirely?" No, the end user still wants some
10 degree of customization.

11 Okay. So how can we fit that into a
12 structure that's not going to run the same risk that we
13 had with pure OTC? They said, "Okay, you can keep
14 customization, but you're going to have to execute
15 these things on a SEF. You're going to have to clear
16 them, unless you are somehow insulating this from the
17 financial sector as a whole; i.e. by doing it end-user
18 to end-user that would give you an end-user exemption."

19 Similarly, if there is something that is so
20 exotic that doing it through clearing and trading would
21 cause a systemic problem within the primary market, you
22 can also do that on the side so it doesn't blow

1 everything up.

2 Okay. Great. So then you've got the IDBs,
3 and they say, "Fantastic. We'll become SEFs. We have
4 a three hundred trillion dollar pie here that's been,
5 you know, baked up the dealers and now served up by
6 Congress and we want a slice, except now we have a
7 problem because the pie seems to be getting smaller,
8 since, you now, a lot of it is starting to be served
9 chez ICE and chez
10 CME."

11 And so the question I think we've got to be
12 asking here from the public interest perspective, from
13 a regulatory perspective, is why is the pie shrinking?
14 Is it simply because there is some sort of regulatory
15 loophole when it comes to futures? And sure enough, I
16 think plenty of people have identified the fertile
17 areas to be looking in that regard -- block trades,
18 core principle 9.

19 You know, is it simply the case that yes, the
20 futures -- the DCM's have been in this game for a long
21 time, but the game has now changed, and so what once
22 worked, letting these guys decide a lot of their own

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1 rules, may no longer be appropriate now that the stakes
2 have become so much higher. These are issues that the
3 Commission needs to be looking into.

4 On the flip side though, there are clearly
5 other things going on here and I would say that re-
6 futurization is actually clear evidence that end users
7 had other reasons for trading on the OTC markets beyond
8 the availability of customization.

9 So what could those reasons be? Well, if I'm
10 and end user using OTC, other than customization, what
11 were the perceived advantages I may have had?

12 Number one, no margin. You know, you wonder,
13 what are the biggest charities in the world? You might
14 think Oxfam, Action 8, and so on. Apparently, it's
15 actually Goldman Sachs, J.P. Morgan, because if you
16 believe the figures, they gave out about a trillion
17 dollars of free hedges to the end user community by not
18 charging a margin, which is very generous.

19 Of course, we know that -- and I should just
20 say that I don't necessarily agree with the trillion
21 dollar figure, right -- maybe the Bank of England, \$200
22 billion, is more appropriate -- but whatever figure you

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1 want to put on it, we all know that that wasn't given
2 away for free.

3 You know, credit charges were imbedded in the
4 prices of swaps and so -- okay, maybe I didn't have to
5 pay margin and maybe I had cash freed up in some way as
6 a result of that, but you know, that cash was probably
7 not just being given to me for free, it was costing me
8 in other areas -- in the price of my swaps, in other
9 words.

10 Okay. So that's one thing, there's the no
11 margin issue, and then the other thing -- well, I had
12 opacity. Okay. So that gave me a lot more flexibility
13 when it came to my balance sheet. You might say too
14 much flexibility. We all know some pretty good
15 examples of end users who were doing some pretty
16 terrible things with that flexibility.

17 Either way you look at it though, Dodd-Frank
18 came in and said, "Okay, sorry, those two advantages,
19 they don't exist anymore. We're not going to have
20 improper risk management. We're not going to have
21 opacity anymore."

22 That's part of the law now that that doesn't

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1 exist, so you've lost a couple of things as an end
2 user. You've lost the ability to cook your books by
3 using OTC derivatives. You've lost the privilege of
4 funding Lloyd Blankfein's bonus by paying him better
5 credit charges than your swaps.

6 But on the other hand, you know, you've
7 gained quite a lot of things, right? I mean, you've
8 basically gained competitive pricing and more
9 transparency.

10 You do have the best of both worlds, and in
11 fact that was exactly what was intended and exactly
12 what the Commission is trying to put into place here.
13 You can still customize, you just have to pay the
14 appropriate prices and, you know, from our perspective
15 -- from the public interest perspective, and I think
16 realistically from the end user perspective, that's a
17 pretty good tradeoff.

18 MR. CAMPBELL: I want to thank you again for
19 the opportunity to speak on two panels, and I'll try to
20 take a different tact on the points I'm going to
21 address today.

22 I think a number of the technical issues have

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1 already been addressed by the folks to my right. You
2 know, the appeal of a free hedge. It makes me think of
3 a free lunch. I didn't have to pay for lunch today,
4 but somehow or another I'll pay for it in the end, I'm
5 sure, so I don't think that ever exists.

6 The perspective maybe I can try to bring is
7 this. I've been with Deloitte for almost fifteen years
8 - - and it's part of the same practice -- and so I have
9 some sense of trends that have moved through the energy
10 markets as they've deregulated, as they've been
11 actively traded, thinly traded, both on the large
12 trading, large operators, all the way down to small
13 operators -- small, even special entities.

14 And some of the trends that have come through
15 -- and maybe that'll help maybe to point towards some
16 of the issues I think that the Commission could be
17 addressing here.

18 If I look at Title VII, and just the Title
19 VII aspects of Dodd-Frank, it feels very similar -- and
20 I use the analogy a lot when I'm working with clients
21 on solving problems -- if you're familiar with the
22 hedge accounting rules that came out of the early part

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1 of the 2000 -- so it's really around FAS 133 and how
2 those evolved into ASC 815.

3 The hedge accounting rule actually feels a
4 lot like this where we went through this period of we
5 had -- you know, what I've described as maybe rules
6 were written for large financial entities and then they
7 made their way down to the end users, to energy
8 companies -- and it was a number of years before we got
9 to good interpretation and guidance in terms of how
10 those should be implemented.

11 It feels very similar to that in terms of the
12 time it's taking to work through this, as well as the -
13 - I would say lack of preparation, or readiness, on
14 behalf of the energy companies -- they struggled with
15 that for a number of years.

16 We saw that from Deloitte's perspective, both
17 as an auditor as well as a consultant, and I'll say
18 that the same issues and the things I'm going to talk
19 about feel very similar to that.

20 So, the perspective we're bringing in is
21 we're on the ground with a wide range of clients across
22 North America trying to implement these rules, and as

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1 it gets to specifically the swaps and futurization --
2 you know, the thoughts we have are, do we have to build
3 a new system for this? Do we have to build a new
4 process? Do we have to build a customized tool? Can
5 we get this done in Excel? How do we do this -- and,
6 you know, to come back to what Lael said -- how do we
7 make sure companies are complying and help them do
8 that? And how do we do that as efficiently as
9 possible?

10 And so the move from swaps to futures I would
11 say has been incredibly efficient. In terms of a
12 compliance requirement, it's been very beneficial to
13 most energy companies.

14 I'll try to talk about some of the exceptions
15 as well as maybe some of the unintended consequences
16 that I could see potentially coming out of that. I
17 would refer back to, again, as I think about the broad
18 market, and not just talking about the market as a
19 whole, but really the segmentation within that.

20 So not the swap dealers and how they'll all
21 be effected by this, and maybe not even the large
22 trading companies that are kind of these -- the

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1 tweeners -- nor the companies that have just now, I'd
2 say, moved away from anything to do with swaps
3 whatsoever, but the companies that fall into that other
4 category. And this, I'd say, solely hits the end
5 users, mid-size utilities, anybody in the energy space
6 that hedges in a variety of different ways, but
7 sometimes intermittently.

8 And I think the first thing to do is look at
9 the period of time we're dealing with, and from an
10 economic standpoint, you know, we're dealing with
11 incredibly low gas prices on a historic level,
12 volatility is as low as it's been in a while, and so as
13 we think about these issues and the problems they may
14 be creating for people by not having liquidity in a
15 cleared market -- or an uncleared market -- were
16 thinking about that because people actually aren't
17 hedging very actively right now.

18 If we were having this conversation four
19 years ago when gas prices were moving at eight and nine
20 dollars -- the call that it's going to put on liquidity
21 -- what that would do to margin, and frankly, just
22 people to be willing to enter the market -- it would be

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1 a very different story.

2 I don't know when gas prices are going back
3 up. You know, we could poll maybe some of the other
4 people on the panel. They certainly probably have a
5 view on when they will or when they'd like them to go -
6 - probably sooner rather than later -- but I'm quite
7 sure they are going to go back up, and I would expect
8 commodity prices, besides what we've seen in the ag
9 space, on the power side, also to ramp up.

10 It's a normal, mean reverting process, and so
11 I'd expect to see a return to high gas prices, high
12 power prices, at some point in the future.

13 And then you're going to have these companies
14 that have been sitting on the sidelines, not having to
15 actively hedge, reenter the market. And it's when they
16 reenter the market that that's when we tend to see, I
17 would say, discontinuity in their ability to actively
18 manage their risk.

19 And so as I think about the unintended
20 consequences of this, it's the people that are making
21 those markets for them and going away and moving to a
22 cleared environment, and then not being able to provide

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1 products to people, I think that's a real risk that
2 maybe we're overlooking right now.

3 And so maybe that's two years down the line,
4 maybe that's three years down the line, maybe it's this
5 summer if we get a big hurricane going through the
6 Gulf. It's hard to predict when these things are going
7 to happen, but I feel relatively comfortable in saying
8 that it likely will happen again.

9 And so -- I think it was Tom Farley, on the
10 previous panel, who said, you know, give this some time
11 to think how it's going to move through, to understand
12 really what all of the changes are going to be before
13 maybe passing further rules.

14 I think providing the opportunity to keep an
15 uncleared swap market out there, as well as the
16 participants in that -- from the brokers all the way
17 down -- I think is a vital piece of that because when
18 you are dealing with people that have operational risks
19 that are tied to, you know, their liquids production --
20 their liquids processing -- there's a very limited
21 number of people that can actually participate in that
22 market.

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1 And the people that are willing to provide
2 very tailored, small lot products to end users -- there
3 aren't a lot of people that can step into that -- and
4 so if the market for that goes away in the uncleared
5 swap business, I think you could actually have some,
6 again -- the unintended consequences of people not
7 being able to manage their risk. I really view that as
8 a significant concern.

9 The other one is -- because there has not
10 been a lot of pressure to hedge because commodity
11 prices have been low -- if you look at the state
12 commissions, they have not been pushing the utilities
13 that are still regulated to put in hedging plans around
14 their gas purchases -- I would say most companies
15 actually don't have a lot of experience in managing
16 liquidity, and managing liquidity risk, and so they'll
17 be fairly comfortable entering a futures market now --
18 or a future swap market now -- because it's not putting
19 a lot of burden on them.

20 But if you move back to where volatility is
21 moving at 50% or 100% in a gas or power market, and
22 suddenly they have to start managing it, most of them

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1 don't have the adequate processes or systems in place
2 to manage that.

3 And so again, that's an issue that isn't
4 going to -- I'll say -- pop up today, but something
5 that's going to pop up in a year or two, and then I
6 would say again, create that issue for the people that
7 are actually just trying to manage their risk.

8 I think those are really -- probably, you
9 know -- really serious things. They're not going to
10 happen next month, but I could see them coming up in a
11 year or two, and I'd be fairly concerned with that.

12 You know, the last -- and I think Luke
13 touched on it -- we were talking at the break about
14 this -- as it comes to providing more guidance to them,
15 for the larger companies, they are sophisticated enough
16 that they have the resources to put in implementation
17 plans in to ensure in compliance.

18 For the smaller ones, they're -- I'll say --
19 very much struggling with this, both from awareness
20 standpoint, as well as just having the tools to do it.
21 I was telling Luke, you know, we built kind of a quick
22 start methodology -- it's almost a Dodd-Frank in a box

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1 to give to smaller clients -- so they could do it on an
2 affordable basis.

3 To the extent you can provide more clarity,
4 specifically around the swaps and futures in what's in
5 and what's not, and how the they'll manage the
6 uncleared environment, I think that would be very
7 helpful to see from the Commission.

8 Thank you.

9 MR. SHILTS: Okay. Thank you all. I don't,
10 myself, have any questions. Does anyone else here have
11 any questions you want to ask? I think the issues and
12 concerns were expressed pretty clearly, and it's been a
13 long day.

14 Commissioner O'Malia? Chairman Gensler? Do
15 you have any questions you want to ask of the panel
16 before we adjourn?

17 All right. Does anyone else have any further
18 comments they want to make before we adjourn for the
19 day? Any of the panelists?

20 All right. With that, then I want to thank
21 everyone. I appreciate you sticking with us for an
22 extra hour as we went over, but the discussions were

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1 very interesting, and it's always nice to have a lot of
2 people wanting to participate and then having a lot to
3 say, and it's been very productive.

4 So, again, thanks everyone, and with that, I
5 think we will conclude the roundtable for today.

6 (Whereupon, at approximately 3:59 pm, the
7 above- referenced meeting of the Commodity
8 Future Trading Commission was adjourned.)

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