

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION

OPEN MEETING ON THE THIRTEENTH SERIES OF
PROPOSED RULEMAKINGS UNDER THE DODD-FRANK ACT

Washington, D.C.
Tuesday, April 12, 2011

1 PARTICIPANTS:

2 Commission Members:

3 GARY GENSLER, Chairman

4 BART CHILTON, Commissioner

5 MICHAEL V. DUNN, Commissioner

6 JILL SOMMERS, Commissioner

7 SCOTT D. O'MALIA, Commissioner

8 Division of Clearing and Intermediary

8 Oversight:

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10 JOHN LAWTON

11 TOM SMITH

12 ANANDA RADHAKRISHNAN

13 THELMA DIAZ

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1 PROCEEDINGS

2 (9:30 a.m.)

3 CHAIRMAN GENSLER: Good morning. This
4 meeting will come to order. This is a public
5 meeting of the Commodity Futures Trading
6 Commission to consider issuance of proposed rules
7 under Dodd-Frank Act for the Margin Requirements
8 for Uncleared Swaps for Swap Dealers and Major
9 Swap Participants.

10 I just want to check whether our
11 technology is working before I move on.
12 Commissioner Dunn was going to be joining us, I
13 think, from Chicago, Commissioner Chilton. So I
14 just wanted to just before I go any further to see
15 if we've everybody signed in.

16 COMMISSIONER CHILTON: I'm here.

17 COMMISSIONER DUNN: Mr. Chairman, this
18 is Commissioner Dunn. I am here in Chicago.

19 CHAIRMAN GENSLER: Terrific. Good to
20 see you, Mike, and I think I heard Bart as well.
21 Is that right?

22 COMMISSIONER CHILTON: Yes, sir, Mr.

1 Chairman.

2 CHAIRMAN GENSLER: Great. The
3 Commission will consider the proposed rulemaking
4 related to conforming amendments to current CFTC
5 regulation that was advised on today's meeting
6 agenda, but we're going to take that up at a later
7 meeting.

8 And before we hear from staff, I'd like
9 to thank Commissioners Dunn, Sommers, Chilton, and
10 O'Malia for all their thoughtful work on
11 implementing Dodd-Frank Act. I'd like to welcome
12 the public as we normally do, and market
13 participants, and members of the media to today's
14 meeting, as well as welcome those listening to the
15 live webcast.

16 We look forward to receiving your public
17 comments on this proposed rule that we're
18 considering today. The rule, as well as a fact
19 sheet and questions and answers document, will be
20 posted on the website. I think this is our 13th
21 meeting, but sometimes Commissioner Sommers
22 corrects my number. But I think we're 13.

1 The proposed rule that we're considering
2 today, normally the proposed rules stay open for
3 60 days, but as we're taking up the capital rule,
4 and, as one of my fellow commissioners said, it's
5 a little like peanut and butter, the two go
6 together. I think we're going to make sure this
7 proposal stays open until at least the last day
8 that the capital rule is open, whenever we take
9 that up.

10 The rulemaking team will present today's
11 work, and I very much appreciate all of their hard
12 work with their commissioners and fellow
13 regulators. They'll present this rule. And, at
14 the same time today, I believe that the credential
15 regulators are what many in the public might call
16 the bank regulators, are also taking up a similar,
17 though not identical, and we'll get into that a
18 little bit in this hearing, rule as well.

19 I will be supporting the proposed rule,
20 which addresses Margin Requirements for Uncleared
21 Swaps entered into non-bank swap dealers, because
22 the prudential regulators have the banks, and

1 non-bank major swap participants. These will be
2 for trades between the swap dealer, or major swap
3 participant, and the rules would require paying
4 and collecting initial and variation margin that's
5 between the dealers and the dealers.

6 The rules for trades between the dealers
7 and financial entities would require collecting,
8 but not paying, initial and variation margin. And
9 on an issue that I think I've spoken on and this
10 Commission has signed on as to various testimonies
11 I've put forward, the proposed rule would not
12 require margin to be paid or collected on
13 transactions involving non-financial end-users
14 hedging or mitigating commercial risk.

15 Congress had recognized the different
16 levels of risk posed by transactions between
17 financial entities and swap dealers, but reflected
18 that non-financial end-users would have an
19 exception from clearing. These transactions
20 involving non-financial entities don't pose the
21 same risk to the financial system as those solely
22 between financial entities. And I think the risk

1 of a crisis in the future spreading through the
2 financial system is greater the more
3 interconnected financial entities are as
4 contrasted with non-financial entities. So the
5 CFTC staff is about to propose something that
6 moves that issue, I think, to the side, and that's
7 part of why I support this.

8 In terms of the financial entities, it
9 also allows that there might be some thresholds
10 for the collection of margin if they're regulated
11 financial entities, like insurance companies or
12 banks, and so forth.

13 I just want to mention one thing that is
14 not on margin. Before today's meeting, the
15 Commission separately voted to proposed rules
16 establishing swapped data, record keeping, and
17 reporting requirements for swaps entered into
18 prior to enactment of the Dodd-Frank Act. I think
19 we had calendered it for our last meeting.
20 Because of some technical things in the document
21 itself, we decided not to actually vote at the
22 meeting, and we have taken that up in what's

1 called seriatim. That proposed rule provides
2 clarity concerning what records must be kept and
3 what data must be reported to swap data
4 repositories with respect to the historical swaps.
5 And that has been sent to the Federal Register,
6 and will be posted to our website with the talking
7 points and Q&A as well.

8 Before we hear from staff, I'll turn to
9 my fellow commissioners, I think recognizing
10 Commissioner Dunn from Chicago.

11 COMMISSIONER DUNN: Thank you, Mr.
12 Chairman, and thank the staff for the hard work
13 that they've done in preparing this particular
14 rule.

15 I am here in Chicago, and this morning I
16 had a little overview of how we're modifying our
17 current stand program, be able to, or at least get
18 a different platform, so we can implement this
19 type of a program. I want to thank everyone for
20 the hard work that they have in putting this in.

21 During the financial crisis, derivatives
22 clearing organizations that have mandatory

1 clearing and margin requirement met all their
2 financial obligations without the infusion of any
3 capital from the Federal government. This was not
4 the case in the world of uncleared swaps. Today's
5 staff presents us with a proposed rule laying out
6 the margin requirements for uncleared swaps.

7 When reviewing this proposed rule on
8 margins, it's important to remember that AIG wrote
9 approximately \$1.8 trillion worth of credit
10 default swaps. AIG did not post initial margin or
11 pay variations on many of these transactions
12 because of their AAA credit rating. Once the
13 subprime crisis hit, AIG was subject to large
14 margin calls that it could not pay. On the brink
15 of bankruptcy, that had the very possibility of
16 causing a global financial meltdown. The U.S.
17 government poured billions of dollars into AIG,
18 the majority of which went to pay through
19 counterparties on AIG derivatives deal.

20 If AIG had been required to post initial
21 margins or pay variations, in all likelihood they
22 never would've been able to enter into \$1.8

1 trillion worth of swaps.

2 The story of DCOs who met all their
3 financial obligations and AIG, who needed a
4 massive government bailout to survive, illustrates
5 the importance of margins in the cleared and
6 uncleared world. In my opinion, companies like
7 AIG simply cannot be allowed to amass swaps
8 positions so large that without paying the
9 necessary levels of initial and variation margin.
10 Without margin requirements, positions of such
11 magnitude will again threaten to destabilize the
12 entire financial system.

13 I would like once again to thank the
14 staff of CFTC for all their hard work in regard to
15 these very important proposed rules. Their
16 dedication to the important work during this
17 difficult time is what government services is all
18 about.

19 I know there is a lot of concerns about
20 end-users on margins; I look forward to get the
21 public comments on this. I will keep an open mind
22 on it. Once again, it is up to the industry and

1 the public to direct the way the Commission will
2 go on this particular rule. Thank you.

3 CHAIRMAN GENSLER: Thank you,
4 Commissioner Dunn. Commissioner Sommers?

5 MR. SMITH: Thank you, Mr. Chairman.
6 Today we are considering one of the centerpieces
7 of the new regulatory structure under the
8 Dodd-Frank Act. The Act requires that the CFTC,
9 the SEC, and prudential banking regulators
10 establish comparable, initial, and variation
11 margin requirements for uncleared swaps to the
12 maximum extent practicable.

13 The importance of achieving consistency
14 is a theme that runs throughout the Act, and is
15 something that I believe is critical, not only
16 with respect to the rules being promulgated by our
17 fellow domestic regulators, but internationally as
18 well. We should not be creating opportunities for
19 regulatory arbitrage. And I want to say that I
20 appreciate all the work of the staff, what you've
21 done to attempt to help create this consistency.

22 I am mindful that substantive

1 differences exist between the approach to Margin
2 for Uncleared Swaps that we are considering today
3 and the approach being considered by the EU as
4 part of the European market infrastructure
5 regulation, or EMIR, could have far-reaching
6 effects.

7 My understanding is that EMIR currently
8 does not contemplate a two-way exchange of initial
9 margin. While I'm supportive of today's proposal
10 on Margin Requirements for Uncleared Swaps for
11 Swap Dealers and Major Swap Participants, I
12 believe that we must continue to work to harmonize
13 our rules internationally.

14 Likewise, although the Margin Proposal
15 before us today is broadly consistent with the
16 proposal being considered by prudential
17 regulators, there are some important differences,
18 particularly with respect to commercial end-users.
19 I believe that the CFTC staff recommendation is
20 consistent with congressional intent that
21 commercial end-users be given the flexibility to
22 continue to do business as they have before.

1 However, I think that all regulators must be
2 mindful of the potential negative economic
3 consequences as we continue to overlook the
4 increased costs that these regulations may be
5 imposing on hedgers and risk management tools.

6 I want to thank the team for all their
7 work and hard efforts to coordinate with others on
8 this proposal, and I look forward to the public
9 comments on this particular issue and on other
10 aspects of this proposal.

11 CHAIRMAN GENSLER: Thank you,
12 Commissioner Sommers.

13 Commissioner Chilton.

14 COMMISSIONER CHILTON: Thanks, Mr.
15 Chairman. Just quickly, thank you to the staff.
16 I think this is one of those rules where we had
17 the possibility of sort of overreaching, and I
18 think the staff got it right. We'll see in the
19 comments. But it had the potential to go too far,
20 and I think they struck a really good balance, and
21 I thank them for that work.

22 I also agree with probably all of you,

1 but what Commissioner Sommers was saying about the
2 harmonization. This is going to be increasingly
3 important as we get into the final rulemaking
4 phase. And, Mr. Chairman, you've done a great job
5 when you were over there three weeks in moving the
6 ball forward. It's a tough balancing act.
7 Everybody has their own sovereign issues. They've
8 got multiple sovereignty issues in the EU. But I
9 think we'll get through it, and I think if we
10 continue to work like we have been, that we'll
11 have more efficient, effective markets overall,
12 and this is a good step with regard to margins for
13 uncleared swaps. Thank you.

14 CHAIRMAN GENSLER: Thank you,
15 Commissioner Chilton.

16 Commission O'Malia.

17 COMMISSIONER O'MALIA: Good morning.
18 Thank you, Mr. Chairman. Let me thank the team,
19 which has spent many long hours developing the
20 Margin Rule Proposal today before us. You've done
21 a good job of developing a proposal that I believe
22 is more consistent with the Act, and I appreciate

1 that.

2 Today we're voting on a similar, but not
3 identical, rules as the prudential regulators.
4 Despite endless attempts to conform the rules,
5 treatment of end- users couldn't be further apart.
6 The rules proposed by the prudential regulators
7 will require that end-users pay initial margin and
8 variation margin to banks. The Commission rules
9 require transaction between swap dealers and
10 end-users to simply include a credit support
11 agreement. Unfortunately, this is not the only
12 inconsistency.

13 Another concern I have is that we are
14 moving forward on a margin rule without defining
15 the new capital requirements. Throughout this
16 entire rulemaking process, participants have
17 complained they can't see the entire picture.
18 Today's rulemaking is no different. End-users
19 will need to wait a couple more weeks before they
20 see the entirety of the new capital end margin
21 regime. I am pleased, however, that the comment
22 period for each rule will run simultaneously. I

1 appreciate that, Mr. Chairman.

2 I believe the commercial end-users and
3 many of the financial end-users will be
4 dissatisfied with the lack of harmonization among
5 the different regulatory bodies. And I will vote
6 against today's Margin Proposal for the following
7 reasons:

8 First, the proposed rule states that the
9 policy behind the Commission's margining regime is
10 to, quote, "create the proper incentives for
11 moving more transactions into central clearing."
12 This line of thinking is representative of the
13 Commission's failure to accept Congress' view that
14 uncleared swaps must be treated differently than
15 cleared swaps.

16 According to the Dodd-Lincoln letter,
17 quote, "Congress clearly stated in this bill that
18 the margin and capital requirements are not to be
19 imposed on end-users, nor can the regulators
20 require clearing for end-user trades," end quote.
21 The prudential regulators have decided to
22 disregard the policy behind the end-user

1 exemption, the intent Congress expressed in the
2 Dodd-Lincoln letter, and, more recently, the
3 bipartisan letter from Chairman Stabenow, Chairman
4 Johnson, Chairman Baucus, Chairman Lucas received
5 on April 6th regarding the treatment of end-users.

6 I believe the major concern of the
7 Congress is a concern I share, that we are
8 imposing increased costs on non-systemically
9 relevant commercial firms who will now be faced
10 with the decision of hedging risk or investing in
11 their business.

12 Second, I'm also struck by the fact that
13 prudential regulators are hiding behind the safety
14 and soundness language in the Act to draft rules
15 that prohibit bank swap dealers from posting
16 margin to their counterparties. To be clear, this
17 is a one-way posting of margin. Banks will not
18 post margin to end-users, financial or commercial.
19 What does this mean in reality? First, it
20 decreases the incentive for counterparties to
21 conduct a credit analysis on the banks because the
22 rules are implicitly signaling to the market that

1 regulated banks are too big to fail. Second, it
2 institutionalizes purchasing and negotiating power
3 on one side of the commercial transaction.
4 Finally, it will now be much more expensive for
5 end-users to hedge their commercial risk using
6 uncleared customized swaps.

7 Finally, today's rulemaking leaves open
8 the possibility that end-users will be assessed
9 margin. The Commission's own proposal states that
10 each swap dealer may accept margin in a manner
11 agreed to by the parties in a credit support
12 arrangement, although no margin obligations are
13 technically required to be imposed on
14 non-financial entities, but this may be cold
15 comfort to end-users. But I look forward to their
16 input.

17 It also does nothing to prevent indirect
18 price increases from swaps for end-users due to
19 capital charges, but that we will deal with in the
20 next rule.

21 I will say this: Many of my concerns
22 regarding the margin and capital rules hinge on

1 the definition of swap dealer. I have read many
2 of the comments, and I see a reoccurring theme.
3 The definition is too broad, and the exception is
4 too narrow. As a result, it is clear that our
5 proposal captures legitimate end-users as swap
6 dealers, and it appears to miss the mark of the
7 rule.

8 I'm also frustrated that today's
9 proposal has paid very little attention to swap
10 dealer banks that are captured by the Section 16
11 push out rule, which will be regulated by the CFTC
12 within the next two years. While I find no
13 justification for the lopsided treatment of end-
14 users throughout the bank regulator margin
15 proposal, I certainly would have preferred that
16 they not require end- users to post margin, to
17 push out swap dealers during the 24-month
18 transition period.

19 This rule is also the poster child for a
20 failed cost benefit analysis. I'm trying to
21 understand what the costs associated with the
22 segregation of collateral at a custodian bank

1 because it certainly won't be free. What are the
2 costs associated with posting margin, and what
3 benefits do we gain from allowing margin
4 requirements to be imposed on commercial end-users
5 that pose little, if any, systemic risk to the
6 financial system?

7 In short, we did not conduct a robust
8 cost benefit analysis, which is consistent with
9 the President's own executive order.

10 Before I close, I would like to make a
11 comment regarding the rulemaking schedule going
12 forward. Mr. Chairman, I know that you've
13 discussed and have proposed a roundtable on the
14 rulemakings, which I support and appreciate your
15 initiative. And at the end of the roundtable, I
16 suggest that the Commission release a
17 comprehensive schedule, the sequencing of the
18 final rulemaking, and a proposed implementation
19 plan in the Federal Register, and allow the public
20 60 days to comment before we finalize the rules
21 going forward. This level of transparency will
22 give the market a clear picture of what is coming

1 and the certainty it needs to make critical
2 investment decisions to be in compliance with the
3 rules upon implementation.

4 I think everyone appreciates that we
5 will not be able to implement all the rules in
6 time to comply with the statutory deadlines. I
7 think we ought to put an end to the artificial and
8 arbitrary deadlines and work to implement a
9 completely transparent final rulemaking and
10 implementation process going forward.

11 In closing, I will not support today's
12 rule, and I would strongly encourage the public to
13 identify the cost burdens associated with the
14 rulemaking in the comment letters they submit to
15 the Commission and to the prudential regulators.

16 Thank you.

17 CHAIRMAN GENSLER: Thank you,
18 Commissioner O'Malia.

19 I think now I turn it over to Ananda
20 Radhakrishnan, John Lawton, Thelma Diaz, and Tom
21 Smith to present today's staff recommendation.

22 MR. LAWTON: Good morning. The proposed

1 rules before the Commission address Margin
2 Requirements For Uncleared Swaps entered into by
3 Swap Dealers And Major Swap Participants. They
4 would implement Section 431(e) of the Commodity
5 Exchange Act -- I'm sorry, 4s(e) of the Commodity
6 Exchange Act, which was added by Section 431 of
7 the Dodd- Frank Act.

8 The rules would apply to swap dealers
9 and major swap participants not subject to
10 regulation by either the Federal Reserve Board,
11 the Office of the Comptroller of Currency, the
12 Federal Deposit Insurance Corporation, the Farm
13 Credit Administration, or the Federal Housing
14 Finance Agency. Collectively, those entities are
15 referred to as the prudential regulators.

16 In developing these rules, Commission
17 staff has consulted with the prudential
18 regulators, as well as with the staff of the
19 Securities and Exchange Commission.

20 As required by Section 4s, the CFTC
21 staff and staff of the prudential regulators have
22 attempted to make their respective proposals

1 comparable to the maximum extent practicable. We
2 understand that the prudential regulators will
3 also be voting on proposed rules today.

4 I'm going to address five topics this
5 morning in presenting this proposal: What
6 products would be covered by the rule, what market
7 participants would be covered by the rule, how
8 margin would be calculated, what forms of margin
9 would be acceptable, and the location of margin,
10 where it would be held.

11 First, with regard to the products
12 covered, the proposed rules would apply to swaps
13 entered into after the effective date of the rule.
14 The rules would not apply retroactively.

15 With regard to the market participants,
16 the proposal would apply to swap dealers and major
17 swap participants not subject to oversight by the
18 prudential regulators. As I'll discuss in more
19 detail in a moment, the rules would not require
20 commercial end-users to post margin.

21 Consistent with the risk-based mandate
22 set forth in Section 4s, the margin treatment

1 under the proposal would vary by counterparty.
2 The way we thought about it is there are sort of
3 three tiers of trades: Trades between swap
4 dealers or MSPs and other swap dealers or MSPs,
5 trades between swap dealers or MSPs and financial
6 end-users, and trades between swap dealers or MSPs
7 and non-financial end- users.

8 The definition of financial end-user for
9 this purpose is based on the definition in Section
10 2(h)(7) of the Act, which addresses the exemption
11 for mandatory clearing. The definition of
12 non-financial end-user is basically anyone who is
13 not a swap dealer, an MSP, or a financial
14 end-user.

15 Okay. So moving to the first year,
16 which would be trades, swap dealer to swap dealer.
17 In those cases, a swap dealer MSP, subject to the
18 Commission, would be required to collect both
19 initial margin and variation from its
20 counterparties that were also a swap dealer MSP.
21 They would be required to collect the entire
22 amount calculated; that is to say, there would be

1 no thresholds allowed. We understand that the
2 prudential regulators proposal is the same in this
3 regard.

4 The effect is to require two-way initial
5 margin and two-way variation margin from swap
6 dealer to swap dealer, swap dealer to MSP; that
7 is, that each swap dealer MSP will be subject to
8 either the CFTC rules or to the prudential
9 regulators rules, and it will be required to
10 collect under the rules to which it is subject.
11 So, if one is subject to the CFTC and one is
12 subject to a prudential regulator, the CFTC swap
13 dealer will collect pursuant to the CFTC rule, and
14 the prudential regulator's swap dealer will
15 collect pursuant to the prudential regulator rule.

16 Moving now to the second tier, or
17 trades, between swap dealers, MSPs, and financial
18 entities, the rules would require the swap dealer
19 MSP to collect initial margin and variation margin
20 from its counterparties. Thresholds would be
21 permitted for some, but not all, financial
22 entities.

1 The standard for qualifying for a
2 threshold would have three elements: The
3 financial entity must be subject to capital
4 requirements by a bank or an insurance regulator,
5 the financial entity must have a swap portfolio
6 below a specified size, which is basically keyed
7 off of the definition of major swap participants,
8 essentially about half, and the financial entity
9 must use swaps predominantly to hedge.

10 A key difference between the
11 requirements under this tier and the first tier is
12 that for swap dealer financial entities, there
13 would be one-way margin; that is, the swap dealer
14 MSP would be required to collect, but would not be
15 required to pay.

16 Staff at the prudential regulators have
17 expressed the view that the reason for this is
18 that it may create risk to the safety and
19 soundness of the regulated entity, that is, the
20 swap dealer MSP, such as a bank, if it was giving
21 margin to an unregulated entity, such as a hedge
22 fund.

1 Again, consistent with the directive in
2 Section 4s that the rules of the Commission and
3 the prudential regulators be comparable to the
4 maximum extent practicable, staff is proposing
5 that this provision also be in the CFTC proposal.
6 Staff of the Commission and staff of the
7 prudential regulators are each going to recommend,
8 however, that the Federal Register release ask
9 questions about this one-way margin and whether
10 there's a rationale for that compared to the
11 rationale for two-way margin.

12 Moving now to the third tier, which is
13 swap dealer MSP to non-financial entity, the
14 proposal would not require that swap dealers or
15 MSPs collect initial margin or variation margin
16 from non-financial entities. This is consistent
17 with congressional intent as expressed in various
18 letters by the chairman of the applicable Senate
19 and House committees. It's also consistent with
20 the lesser risk that such parties generally
21 propose to their counterparties and to the
22 financial system generally. Non- financial

1 entities generally use swaps to hedge and do not
2 have the same degree of interconnectedness with
3 the markets as swap dealers or major swap
4 participants would.

5 The proposal would require that swap
6 dealers and MSPs enter into credit support
7 arrangements with their counterparties.
8 Therefore, a non-financial entity would only be
9 required to post margin to the extent that the
10 parties bilaterally agree in their credit support
11 arrangements independently entered into that that
12 would be done.

13 Turning now to the topic of margin
14 calculation, the proposal would allow initial
15 margin to be calculated pursuant to our model, or,
16 if no qualifying model were available, pursuant to
17 an alternative method that essentially ties the
18 Margin for Uncleared Swaps to the margin for
19 similar cleared swaps.

20 Any model that would be used would be
21 subject to a number of standards. For example, a
22 model would be required to cover 99 percent of

1 price changes over a 10-day liquidation period.
2 By way of comparison, the clearing rules earlier
3 proposed by the Commission for cleared swaps
4 executed on a swap execution facility would
5 require the margin to cover 99 percent of price
6 changes over a five-day liquidation period. The
7 different liquidation time horizons reflect the
8 greater standardization and the greater market
9 liquidity that can be expected for cleared
10 products compared to uncleared products.

11 If no model were available for a
12 particular product or group of products, the
13 proposed alternative proposal would require the
14 participants to identify a comparable cleared
15 product. The parties would then apply a
16 multiplier to the margin level required by the DCO
17 for the cleared product to reflect the greater
18 risk of the uncleared product. This is a point of
19 difference. The proposed alternative model being
20 proposed by the prudential regulators would be
21 based on notional value of the uncleared swap.
22 Again, both the prudential regulator staff and the

1 CFTC staff are recommending that there be
2 questions asked about the pluses and minuses of
3 the different proposed alternative models.

4 The fourth of the five topics that I
5 wanted to touch on today is forms of margin that
6 would be acceptable. For trades in the first two
7 tiers, that is, swap dealer to swap dealer or swap
8 dealer to financial entity, the proposal would
9 specify specific acceptable forms of margin.
10 Essentially, they would fall within the category
11 of cash, treasuries, and various GSE type
12 products.

13 For trades involving non-financial
14 entities, the rules would not specify forms of
15 margin. Again, this would be specified in the
16 credit support arrangements agreed to bilaterally
17 between the parties.

18 To the extent the parties require or
19 permit the use of non-traditional forms of
20 collateral, the proposal would require that they
21 periodically revalue them just to reflect the
22 potential change in the market value of a product.

1 For example, if someone were accepting natural gas
2 and storage as margin for an energy swap, the rule
3 would require that that asset be periodically
4 revalued. And the proposed Federal Register
5 release would ask questions as to how frequently
6 should that be done, and what's feasible, what's
7 appropriate for risk management purposes.

8 The final topic is the location of
9 collateral. Under the proposal, swap dealer to
10 swap dealer trades, collateral would have to be
11 held at an independent third party custodian. By
12 contrast, for trades between a swap dealer and a
13 financial end-user or a swap dealer and a non-
14 financial end-user, the proposal would simply
15 require that the swap dealer offer the
16 counterparty the opportunity to have the margin
17 held in segregation, and that would be at the
18 option of the counterparty.

19 Finally, the proposal, with regard to
20 custodians, would set some limits on how they
21 could invest funds that they're held and would
22 prohibit them from rehypothecating assets that

1 they hold in the custodial account.

2 Thank you, and we're ready to take any
3 questions anyone might have.

4 CHAIRMAN GENSLER: Thank you, John.
5 Thank the whole team. I think I'll entertain a
6 motion to accept the staff recommendation on
7 Margin for Uncleared Swaps for the swap dealers
8 and MSPs we regulate.

9 COMMISSIONER SOMMERS: So moved.

10 COMMISSIONER O'MALIA: Second.

11 CHAIRMAN GENSLER: Having been moved and
12 seconded, I guess it's now open to the floor for
13 questions. And I'll start with a few.

14 I am supporting today's rule, but I'd
15 like to tease out a little bit more where there
16 might be any differences between what we're doing
17 today and the prudential regulators. I applaud
18 the staff because I know it's been seven or eight
19 months of work to comply with the statute in all
20 of its respects, but importantly where it says
21 also to the maximum extent practicable to be
22 consistent. But there are some differences. So,

1 maybe John or Ananda, just if you could highlight
2 what you think the top two, three, or four, I
3 don't mean to limit it, but where are there some
4 differences, if you could?

5 MR. RADHAKRISHNAN: Thank you. First,
6 with respect to the requirement between a swap
7 dealer and an MSP and a non-financial end-user,
8 I'm looking at the draft that was provided by the
9 staff of the prudential regulators yesterday, and
10 it says, "Under the proposed rule, a covered swap
11 entity," i.e., swap dealer or MSP, "...would not
12 be required to collect initial or variation margin
13 from a financial end-user counterparty as long as
14 the covered swap entity's exposures to the non-
15 financial end-user were below the credit exposure
16 limits that the covered swap entity has
17 established under appropriate credit processes and
18 standards." So, this is a subtle difference, but
19 I'm not sure whether it is a difference because in
20 our proposal we are saying there has to be a
21 credit support agreement, and with respect to the
22 exchange of margin, it's all a function of the

1 credit support agreement.

2 CHAIRMAN GENSLER: But I gather, and I'm
3 looking at that page, too, because I read it late
4 last night, but they're saying the swap entity
5 would not be required to collect initial variation
6 margin. We say the same the thing, you would not.
7 They're, of course, regulating banks. They then
8 go on to say this idea of having a credit exposure
9 limit established under appropriate credit
10 processes and standards, so we don't have that
11 because we're not bank regulators. So, that's the
12 difference. We're not mandating there be
13 thresholds.

14 MR. RADHAKRISHNAN: Correct, we're not.
15 We're not. And the one difference is that if a
16 threshold is reached, and it doesn't seem to me
17 that the prudential regulators are insisting on
18 the threshold. But the one difference is if the
19 threshold is reached, then the types of collateral
20 that can be posted are limited to the types of
21 collateral, basically treasuries, cash, and GSEs,
22 whereas we are very clear that our proposal would

1 basically, parties agree, but you've got to allow
2 the use of non-cash collateral.

3 CHAIRMAN GENSLER: Right. So, if I
4 remember the statute, I don't remember the
5 section, but somewhere in 731, it says that
6 Congress mandated the use of non-cash collateral.
7 You're saying we allow that.

8 MR. RADHAKRISHNAN: That's correct.

9 CHAIRMAN GENSLER: One difference that I
10 noticed, and maybe it's a modest difference, but I
11 did notice that the discussion, and I don't know
12 if my fellow commissioners noticed this because it
13 was a document that we all maybe got late
14 yesterday, was reading through the prudential
15 regulator thing. I noticed that I understand the
16 prudential regulators have included a provision in
17 their proposal that would permit portfolio
18 margining of swaps executed prior to the effective
19 date. For the public, I think that the proposed
20 rule that we are proposing would only require
21 margining for post-effective date. So, first, is
22 that correct?

1 MR. RADHAKRISHNAN: That's correct.

2 CHAIRMAN GENSLER: And the Federal
3 Reserve and the bank regulators look like they're
4 doing the same thing. It's only post-effective
5 date margining.

6 MR. RADHAKRISHNAN: That's how I
7 understand it, yes.

8 CHAIRMAN GENSLER: But I noticed that
9 they have about a page and a half where they say
10 that if a bank wanted a portfolio margin, wanted
11 to use some of the pre- enactment or pre-effective
12 date swaps that might help lower margin, that at
13 least the regulators would consider that.

14 MR. LAWTON: Yeah, that's correct. The
15 way that they've phrased it is that you can't pick
16 and choose, that if you're going to include
17 pre-enactment swaps in the portfolio, you have to
18 put them all in or none of them.

19 CHAIRMAN GENSLER: So, I'm wondering,
20 and I'd have to unanimous consent, but I'm
21 wondering whether we should at least include
22 questions that would allow us the flexibility in

1 our final rule if the market thinks that's
2 important. We currently don't have any questions
3 on that, do we?

4 MR. LAWTON: Right. Our proposal is
5 silent on that. It doesn't prohibit such
6 pre-enactment swaps. It's silent. It doesn't
7 state explicitly that they may be included.

8 CHAIRMAN GENSLER: Well, I don't know if
9 other commissioners will have questions on that
10 topic, but whether I should ask it now or later, I
11 think I'd like to at least have the questions.
12 I'd like to retain the flexibility that in the
13 final rule, if the market thinks that's a good
14 idea, that we're consistent. So, I might ask that
15 at the end and let others ask about that.

16 Just a very small point. I noticed a
17 discussion, it was a number of places, but on page
18 20 particularly in our rule, that we talk about
19 marking the positions for variation and maybe
20 initial margining as well. And I thought it would
21 be appropriate to have just a cross- reference to
22 the statute wherein 4s(h), it says that there has

1 to be daily marks. So, it's a small technical
2 thing, but I'd ask unanimous consent to accept
3 just some cross- reference to the statute.

4 Not hearing objection, we can do that.
5 Commissioner Dunn?

6 COMMISSIONER DUNN: Thank you, Mr.
7 Chairman. Again, I want to express my
8 appreciation to the staff for their hard work on
9 this, and I know that doing all the harmonization
10 that needed to take place on this, they did a
11 great job on it.

12 But I would like to zero in on this
13 credit support arrangement that we're talking
14 about there. And for those end-users would able
15 to post that non-cash collateral. What is the
16 role of the CFTC in verifying that there is some
17 there within that arrangement?

18 MR. RADHAKRISHNAN: You mean in terms of
19 the valuation of it?

20 COMMISSIONER DUNN: That's correct, the
21 valuation.

22 MR. RADHAKRISHNAN: Well, first of all,

1 if we're going to examine the swap dealer, we'll
2 probably look at what the credit support
3 arrangement provides in terms of what you can
4 accept as collateral. And then we'll probably ask
5 for supporting documentation to show that
6 collateral has in fact been posted. And then with
7 respect to valuation, I think John mentioned, we
8 do require that there be a periodic valuation of
9 the collateral.

10 But the broader question is, let's say,
11 for example, the collateral provided is natural
12 gas leases or natural gas in storage. Then we
13 and/or the NFA will have to quickly get an
14 understanding of how natural gas is valued.

15 COMMISSIONER DUNN: Mr. Chairman, I note
16 that we did get a modest increase in the deal that
17 was worked out with Congress, and I think that
18 will be very, very helpful. But I would ask
19 Ananda, do we have the resources now to be able to
20 do that type of quick study that he was talking
21 about, and to understand those balance sheets, and
22 what the worth of these assets that are being

1 pledged are?

2 MR. RADHAKRISHNAN: I'll respond this
3 way. If all of the auditors in DCIO moved from
4 their current responsibilities, which are fairly
5 significant, and trained to understand the
6 valuation of non-traditional forms of collateral.
7 And the other issue is we don't know what it is.

8 I don't know about quick study,
9 Commissioner Dunn. We will study it, but it
10 presumes that staff may not be doing other
11 responsibilities. And the reason I answer that
12 that way is because it remains to be seen just how
13 many of these instances we are required to do and
14 what forms of collateral people will accept.

15 COMMISSIONER DUNN: Well, I've said
16 before, when it comes time for a final rule, I
17 really would like to see from the division
18 drafters how they're going to afford to implement
19 that rule. What are they not going to be doing
20 that we're presently doing, because I'm assuming
21 we're 100 percent fully employed, maybe 110 or 15
22 percent fully employed. So, some things that we

1 are currently doing we're not going to be doing.
2 I'd like to know what those are and how the
3 resources are going to be allocated to implement
4 these regulations. I just feel that if we say
5 we're going to do something, we'd better have the
6 wherewithal to be able to do that.

7 We did get a lot of input on end-user on
8 this, and, John, in your opinion, does this rule
9 satisfy the majority of those end-users that had
10 concerns on the pre- writing of this particular
11 proposal?

12 MR. LAWTON: I hope so, but I really
13 couldn't say.

14 MR. RADHAKRISHNAN: Well, we believe
15 that it does to the extent that we are not
16 mandating the collection of margin and pretty much
17 leaving it to the parties to decide. All we're
18 saying is you've got to have a credit support
19 agreement without saying what thresholds people
20 need to have. We're saying you've got to allow
21 the use of non-cash collateral. So, we believe
22 that we are being responsive to the concerns that

1 Page 28, there is a statement that says, "As was
2 the case for initial margin, this is in accordance
3 with the statement in Section 4s(3)(C) that the
4 Commission permit the use of non- cash
5 collateral."

6 CHAIRMAN GENSLER: But we've only
7 allowed it for the non-financial end-users.

8 MR. RADHAKRISHNAN: Correct.

9 CHAIRMAN GENSLER: I would, hopefully
10 Commissioner Sommers will give forbearance, there
11 was something Commissioner O'Malia said in his
12 opening that I will maybe turn you to. On the
13 bottom of page 8 and the top of page 9, there are
14 sentences that if I turn you to, and I'm not even
15 going to ask unanimous consent, we might strike.
16 But it's the last word on page 8, "and", and then
17 the top of page 9, "create the proper incentives
18 for moving more transactions in the central
19 clearing." And I find myself in agreement with
20 Commissioner O'Malia. I don't think the statement
21 is necessary for the rest of it; it's just a
22 preamble statement. But is that necessary?

1 MR. RADHAKRISHNAN: Staff of CFTC does
2 not believe so, but this is language we obtained
3 from the prudential regulators. I just want you
4 to know that.

5 CHAIRMAN GENSLER: Oh, okay. But it's
6 our preamble.

7 MR. RADHAKRISHNAN: Yes, so we can take
8 it out.

9 CHAIRMAN GENSLER: So I'm asking
10 unanimous consent, even though I don't think it'll
11 change Commissioner O'Malia's vote on the overall
12 rule -- I always like to find ways that we can
13 narrow differences -- that we could strike those
14 eight or 10 words.

15 Not hearing objection, they'll be
16 struck. Commissioner Sommers? Sorry.

17 COMMISSIONER SOMMERS: Thank you, Mr.
18 Chairman. I have a couple of different areas that
19 I just want to clarify for those who are
20 interested in what we're doing in this proposal.

21 The first area is where in the proposal,
22 we require that the CSEs calculate hypothetical,

1 initial, and variation margin each day for the
2 non-financial entities because we believe that it
3 would likely be necessary in helping them compute
4 their capital requirements.

5 So, my question, because we're not doing
6 capital today, and because we're not laying these
7 out side by side, to just ask if this consistent
8 with the way current capital requirements are
9 calculated, and if this is something that you
10 think is necessary to be in here because of the
11 way the capital rule will be proposed.

12 MR. SMITH: Yes, it is consistent with
13 the way capital is computed today for futures
14 commission merchants or for broker-dealers. What
15 this is basically saying is we need to mark the
16 position to market and recognize any gains or
17 losses, and also to see if you have any receivable
18 or liability, which is included in the entity's
19 capital. The question then becomes, how do we
20 treat it for regulatory purposes? Do we allow
21 that receivable to qualify as regulatory capital
22 or not? So, this is the first that was just had

1 the calculation.

2 COMMISSIONER SOMMERS: And those
3 decisions will be made in our capital proposal?

4 MR. SMITH: That's correct.

5 COMMISSIONER SOMMERS: Okay. Thank you.
6 Then on the use of proprietary modeling. So we
7 say in the proposal that we will not allow the use
8 of proprietary models unless those models have
9 been approved by prudential regulators. And then
10 I think, you may want to explain this because I'm
11 not going to do a very good job of explaining it.
12 There is an alternative methodology for
13 calculating the margin.

14 Do you contemplate that we may be in a
15 place where having the methodologies blessed so
16 that we can approve those if we don't have the
17 resources to do such a thing, could be delegated
18 to a third party?

19 We talk about independent third party
20 verification, but having some entity, and perhaps
21 even internationally, that would say that certain
22 valuation methodologies have been tested and that

1 all regulators could be able to look to that type
2 of entity, if that's something we could
3 contemplate delegating.

4 MR. RADHAKRISHNAN: I think we could in
5 theory, Commissioner. I think if a movement
6 developed suddenly internationally for an
7 independent entity to develop modeling techniques
8 for margin, and it's got to be specific to margin,
9 and if it meets certain minimum standards that the
10 regulators all can agree on, then it may not hurt
11 the Commission to think along those lines. If you
12 think about margining models in the cleared space,
13 the SPAN, which is pretty much used quite
14 significantly and throughout the world. There is
15 also to a lesser extent TIMS, developed by the
16 OCC. And then they're SPANs. The historical
17 development of SPAN in this agency, staff was
18 involved in looking at it, and now it's gotten a
19 worldwide acceptance.

20 So, if you do find such a movement and
21 if the international regulators do agree on it,
22 then I don't see why we can't consider it.

1 COMMISSIONER SOMMERS: I have concerns
2 in this particular area for us to be creating
3 policy saying that in this proposal what we say is
4 that CSEs, subject to Commission regulations, may
5 not have proprietary models. Given our current
6 budget constraints, the Commission does not have
7 the resources to review numerous models
8 individually, and that we're proposing to permit
9 the use of non-proprietary models. My concern is
10 that we may be putting our registrants at a
11 competitive disadvantage. So, I guess, I would
12 say that I would like to see comments specifically
13 addressed to this area, and what comments may be
14 helpful for this Commission, and how we can move
15 forward in helping us review these type of models.

16 CHAIRMAN GENSLER: Commissioner Sommers,
17 may I ask, do you think that it would help to ask
18 a specific question, again, to retain flexibility
19 that we ask a specific question that's in the
20 document that Commissioner Sommers is asking about
21 this reliance on some internationally, because I
22 would support it if we need it.

1 COMMISSIONER SOMMERS: I don't know if
2 we would be prohibited from using a delegated
3 source, even if we don't include it, right?

4 MR. RADHAKRISHNAN: I don't think so,
5 but if you'd like to ask the question, we can
6 certainly ask it. If I understand you correctly,
7 Commissioner Sommers, if there were to develop an
8 international standard, could the Commission in
9 its rules rely on that. That's the question,
10 right?

11 COMMISSIONER SOMMERS: Right.

12 MR. LAWTON: Just to add one point. The
13 proposal also talks about models developed by a
14 vendor, so I think that if there were some sort of
15 international model, somebody would have had to
16 have developed it, and somebody would have to be
17 making it available. So, I think to that extent,
18 it would be covered under the proposal if it's out
19 there.

20 COMMISSIONER SOMMERS: Thank you. The
21 next line of questioning is with regard to the
22 forms of margin or assets that can be posted. And

1 I was wondering if you could explain the
2 differences between what we will allow for swap
3 dealers, financial end-users, and non-financial
4 end-users, with regard to what forms of margin can
5 be posted, and the differences between what we
6 currently allow in the futures regime, because I
7 think there is quite a difference here for people
8 to be aware of.

9 MR. LAWTON: Yeah. I think that in the
10 proposal. It's fairly narrow. It's essentially
11 cash treasuries and certain other GSE-type
12 entities. In the futures world, it varies from
13 DCO to DCO, and it varies from product to product.
14 But certainly there's a wider number of things, I
15 mean, money market funds being an example that
16 comes to mind, or some DCOs permit equity
17 securities with a pretty big haircut, but they
18 permit equity securities for some products.
19 People permit, for example, gold.

20 I think the non-financial entities is
21 broader still when we start getting into things
22 like natural gas in the ground. I don't think you

1 see that at a clearing house. So on the
2 continuum, the most narrow is what's being
3 permitted for financial entities here. In the
4 middle would be what's permitted by clearing
5 houses. And then the broadest would be what's
6 being permitted for non-financial entities here.

7 COMMISSIONER SOMMERS: And then, with
8 regard to custodial arrangements, something you
9 said in your summary with regard to offering the
10 counterparty the option or requiring that the
11 custodial arrangements between swap dealers or
12 major swap participants be kept at an independent
13 body. But we're offering the counterparty the
14 option. And then there are limits to what they
15 can invest. And so, if you could explain the
16 differences between those custodial arrangements
17 and the limits between this and what we currently
18 see in the futures industry.

19 MR. LAWTON: With the future's industry,
20 basically there's not really limits on custodians
21 under our rules. The custodians would be banks,
22 and so they would be limited in what they can do.

1 The limit under our Rule, Section 4d that says a
2 custodian that receives segregated funds must
3 treat and deal with them as belonging to
4 customers, and they have to sign a custodial
5 arrangement under the Commission regulations. But
6 there's not really investment linked limitations
7 under CFTC rules for a custodian for 4d futures
8 segregated funds. So, that would be a distinction
9 between here and there.

10 COMMISSIONER SOMMERS: Sorry. With
11 regard to requiring that the swap dealers have a
12 custodial and independent custodian, is that
13 different from what normally exists now?

14 MR. RADHAKRISHNAN: That is different.
15 Right now, we don't have an independence
16 requirement. So, for example, an FCM that's
17 affiliated with a bank can custody its customer
18 funds. We monitor this because there is, of
19 course, the issue, which if is a bank goes bust,
20 then the FCM is going to go bust as well. But we
21 don't have any rules that say if you're an FCM,
22 you must keep your customer funds at a depository

1 that you're not affiliated with.

2 COMMISSIONER SOMMERS: What about for
3 the CSE that has a financial entity or a
4 non-financial entity as a counterparty? Did
5 limits to investments versus what we have under
6 1.25, is there a difference? Is there more
7 limitation there?

8 MR. LAWTON: Yeah. This is narrower
9 than 1.25. Again, an example would be money
10 market funds, that this, again, is the smaller
11 category.

12 COMMISSIONER SOMMERS: I guess I would
13 say with regard to this issue as well, I have
14 specific concerns with regard to this, so ask if
15 the public would like to specifically comment on
16 these areas. I think it would be very helpful for
17 us in knowing whether these type of more stringent
18 limitations are going to be anti-competitive or
19 add more costs to doing business. Thank you.

20 CHAIRMAN GENSLER: If I might, because I
21 think Commissioner Sommers asked a very good set
22 of questions, the whole line. But I'm just

1 curious, back to the, if I might. We're actually
2 deliberating. But in the futures model right now,
3 futures commission merchants have to segregate the
4 money, but it doesn't have to be with a separate
5 custodian. Is that what I understood?

6 MR. RADHAKRISHNAN: That's true.

7 CHAIRMAN GENSLER: That's similar to
8 what we're requiring here for swap dealers to
9 financial entity trades. In this rule, we're
10 saying you don't necessarily have to have a
11 separate custodian. Is that correct?

12 MR. LAWTON: That's correct.

13 CHAIRMAN GENSLER: So where we're more
14 restrictive, and that the prudential regulators
15 have, as I understand it, or similar, is it's the
16 dealer to dealer. Is that correct?

17 MR. RADHAKRISHNAN: That's correct.

18 CHAIRMAN GENSLER: Is there much dealer
19 to dealer FCM business in the futures world right
20 now?

21 MR. LAWTON: Well, everything would go
22 through the clearing house in the futures world,

1 so there really wouldn't be a bilateral trade. So
2 the FCM, it would be in their house account.

3 CHAIRMAN GENSLER: So, it would be in
4 their account. So, the analogy is mostly with the
5 financial entity counterparty. So, I do think it
6 would be very helpful to get public comment
7 because it's a little bit different, but may be
8 warranted.

9 MR. RADHAKRISHNAN: And I think also, if
10 you look at it from the banking perspective, I'm a
11 bank, I'm a dealer. If there wasn't an
12 independence requirement, you're basically
13 allowing me to keep my money with myself. So, I
14 think that's why the prudential regulators have
15 those independence requirements.

16 CHAIRMAN GENSLER: And to the extent
17 that our rules might be modestly different than

18 the prudential regulators, they're more flexible,
19 once a bank pushes out its business to the
20 non-bank affiliate, it would have our rules. Is
21 that correct?

22 MR. RADHAKRISHNAN: That's correct.

1 CHAIRMAN GENSLER: Commissioner Chilton?

2 COMMISSIONER CHILTON: Thanks, Mr.

3 Chairman. Two quick things. One, Mr. Chairman,
4 your idea on the portfolio margining idea, I
5 think, is a good one. If we can develop a
6 question to ensure that we have the latitude to do
7 something in the final rule, should we want to do
8 that, I think that's a good idea.

9 I wanted to raise an issue that
10 Commissioner O'Malia raised, but Commissioner
11 Sommers raised it several times, on the cost
12 benefit. And by and large, I think, I agree that
13 to the extent we can do more analysis on cost
14 benefit, it's a good thing.

15 On this one, I think we did a pretty
16 good job based upon what we know, and I'm not sure
17 that we can know a whole lot more. I mean,
18 essentially we've asked for comments, and
19 Commissioner O'Malia mentioned that. The rule
20 asked for comments on the cost benefit. But
21 overall, we say that this is going to be better
22 for markets and better for individuals, and that

1 it'll offset any costs.

2 But, Ananda, I'm curious. I mean, how
3 would you would even go about doing a cost benefit
4 because much of this is discretionary in how
5 individual parties would set it up. So, I'm
6 trying to get a handle on how you think you could
7 do something more than what we've done.

8 MR. RADHAKRISHNAN: Commissioner
9 Chilton, that's part of the issue, because in our
10 cost benefit analysis, we talk about opportunity
11 costs, because if you have to put up margin, the
12 cost is the cost of funding, the opportunity
13 costs. Because you've got to fund the margin, you
14 couldn't do something else with your money, so
15 what are the opportunity costs?

16 And, of course, the other issue has to
17 do with, we're hoping for comment on the totality
18 of the costs. We really don't have a good idea
19 what the totality of the costs will be.

20 COMMISSIONER CHILTON: My point was that
21 there is discretion in what individual parties
22 were coming up with. We are allowing collateral

1 to be used instead of posting margin, but we don't
2 say exactly what it will be. And so, there's a
3 big unknown out there. So, for us to try to make
4 some guess on what individual parties will come up
5 with on a bilateral agreement, what that would
6 cost, I don't know how we would do it. That's my
7 real question.

8 MR. RADHAKRISHNAN: Meaning how much
9 margin would actually be required?

10 COMMISSIONER CHILTON: Right.

11 MR. RADHAKRISHNAN: Yeah, that's right.

12 COMMISSIONER CHILTON: Anyway, I guess
13 my point is, I think we've done a pretty good job
14 on this one. While I agree in concept that the
15 more detail we can get on cost benefit analysis
16 the better, I think on this one, there are so many
17 unknowns that we've done a good job with the
18 information that we had.

19 MR. RADHAKRISHNAN: Thank you. I just
20 want to mention, you were cutting in and out just
21 now when you were talking, so I just want to make
22 sure our telephone guys know that. I don't know

1 whether it's your distance to the telephone.

2 COMMISSIONER CHILTON: Two inches, so
3 I'll try to get closer. Thank you.

4 CHAIRMAN GENSLER: Thank you,
5 Commissioner Chilton.

6 Commissioner O'Malia?

7 COMMISSIONER O'MALIA: Thank you. Along
8 the lines that Commissioner Sommers mentioned, I
9 think the issue of this proprietary model, we
10 talked about it before. We found that, to my
11 frustration, we didn't have a jurisdictional hook
12 with some of these banks, and, more specifically,
13 these push out banks. We're in an intervening
14 time here. They've got two years to push these
15 things out, and then they will be under our
16 jurisdiction. And I'm trying to understand. This
17 doesn't really provide a transition plan. Are we
18 going to trust the modeling that the prudential
19 banks send them over with when they push them out?
20 They're going to have margining requirements under
21 prudential requirements, but when they get over
22 here, will we just lift those and return the

1 money? What's the plan with push outs?

2 MR. RADHAKRISHNAN: In the current rule
3 we're saying that if you want to use a proprietary
4 model that's been reviewed by the prudential
5 regulator, correct me if I'm wrong, though, it has
6 to be approved by the prudential regulator for use
7 by our registrant.

8 COMMISSIONER O'MALIA: By our
9 registrant? At that time it's their registrant.

10 MR. RADHAKRISHNAN: Correct, their
11 registrant. But also, our rule says, let's say we
12 have, I won't name an entity, but let's say you
13 have an entity right now. It's not part of a push
14 out. It's not part of a banking entity. So, it
15 may be affiliated with a banking entity. So we're
16 saying that the regulator has to approve it for
17 use by our entity.

18 So, I guess what we're saying is as long
19 as we don't get any information from the
20 prudential regulator that it stopped allowing
21 somebody to use the model, the presumption is that
22 the prudential regulator is still comfortable with

1 We can send staff to understand how they --

2 COMMISSIONER O'MALIA: I think we have
3 to have a higher level of certainty with these
4 models before we just endorsing them.

5 MR. RADHAKRISHNAN: So, right now,
6 there's no 716 entity right now, so right now it's
7 all the bank. So, if I understand you correctly,
8 let's say two years from now we found out that a
9 particular bank has to push out somebody. Then I
10 think I think at that time we'll find out what it
11 is they want to use. The first question is,
12 they'll have to demonstrate to us that they're
13 using a model that has been approved by the
14 prudential regulator for use by them. So, and I
15 guess at that time it's certainly appropriate for
16 us to have a conversation with the prudential
17 regulator, first, to make sure the entity is not
18 lying to us, and trying to get an understanding of
19 the model itself.

20 COMMISSIONER O'MALIA: Can I ask you
21 another question?

22 MR. RADHAKRISHNAN: Yes.

1 COMMISSIONER O'MALIA: Are the end-users
2 privy to the models used by swap dealers under our
3 jurisdiction or prudential regulators?

4 MR. RADHAKRISHNAN: I'm not sure. I
5 don't think they are. I'm not sure.

6 CHAIRMAN GENSLER: Can I just, because I
7 want to assure, because this is a very important
8 line. But on page 22 of the preamble, I thought
9 we retained the right that if something is part of
10 a bank holding company and has some model approved
11 by the prudential regulators, it's one of these
12 716 push outs, or it's already an affiliate.
13 Don't we retain under this proposal, it says under
14 23.155(b)4, we could approve or deny, and we could
15 set conditions or limitations?

16 MR. RADHAKRISHNAN: That's true.

17 CHAIRMAN GENSLER: I mean, again, I just
18 want to make sure because I agree with
19 Commissioner O'Malia that we don't want to just
20 give up our -- Congress has said we have to do
21 something for non-banks. If we inherit these 716
22 push outs, does this retain -- I mean, it's a

1 question for you, but it's also -- does this
2 retain our --

3 COMMISSIONER O'MALIA: I think it does,
4 and that's my line of questioning. What are we
5 actually doing to be comfortable with this so we
6 can, A, represent this Commission and our
7 registrants in this negotiation with the
8 proprietary model? If we don't understand the
9 model and we can't explain it, how are we going to
10 police it? And I'm trying to understand the hook
11 we'll have immediately. There's no way we can get
12 to the prudentially regulated banks, but those
13 push outs are coming our way.

14 CHAIRMAN GENSLER: And some of them are
15 already there. Some of the banks already have
16 them outside of the bank.

17 COMMISSIONER O'MALIA: Correct. Are we
18 going to rely on them? What capabilities do we
19 have? And then, will end-users be on a level
20 footing with the banks in negotiating these
21 agreements?

22 CHAIRMAN GENSLER: Right. And I think

1 it's an excellent question, and I just want to
2 make sure retain that we can see the models. Is
3 that right, Ananda?

4 MR. RADHAKRISHNAN: Yes.

5 CHAIRMAN GENSLER: Completely. Like
6 it's no black box.

7 MR. RADHAKRISHNAN: No, the models have
8 to be filed.

9 CHAIRMAN GENSLER: And we could set
10 conditions or limitations if we're not satisfied.

11 MR. RADHAKRISHNAN: Right. Page 22,
12 there has to be a filing of the model and an
13 explanation of the manner in which the model meets
14 the requirements, the mechanics, the theoretical
15 basis, the empirical support, and independent body
16 validation. And we reserve the right to impose
17 conditions or deny the use of the model.

18 MR. LAWTON: And I would just add that
19 in the proposed rule, there's also a provision the
20 Commission may require that a covered swap entity
21 to provide further data or analysis concerning any
22 model at any time.

1 CHAIRMAN GENSLER: I think it might help
2 to add some questions on Commissioner O'Malia's
3 thought about transition. Like, what happens if
4 somebody were under the prudential regulator's
5 margin requirement and the business gets pushed
6 out?

7 COMMISSIONER O'MALIA: That's why I
8 opened this. This rule doesn't contemplate that.
9 No later than two years I think is what the Act
10 says that they have to come over to our
11 jurisdiction. But I think we need to prepare
12 ourselves for this and be clear about this thing.

13 You listed all the futures models,
14 margining models that are completely transparent.
15 We understand. I get they're complicated, and I
16 get that we don't have a lot of staff. But we
17 can't make excuses and just hope this goes away.
18 We got more money today, or we're in the process
19 of getting more money, and that's great news. And
20 this isn't always going to be the situation, but
21 we have to be able to stand up on our own. And if
22 we can leverage the resources of the prudential

1 regulators at this point to work with the models,
2 let's take advantage of that.

3 MR. RADHAKRISHNAN: If the Commission
4 can make sure that DCIO gets all money, we'll hire
5 all these people.

6 COMMISSIONER O'MALIA: Well, let me go
7 to a concern that Commissioner Dunn raised about
8 valuating these things. Don't allocate all your
9 staff to looking at oil and gas reserves. I mean,
10 the real bogey in this one is going to be
11 systemically risky entities, and that's not, quite
12 frankly, the oil and gas companies at this point.
13 It's really the clearing houses.

14 MR. RADHAKRISHNAN: Oh, absolutely.

15 COMMISSIONER O'MALIA: So don't put all
16 your auditors over there trying to learn what the
17 business of oil and gas engineering.

18 I'm trying to understand, we have some
19 language, and I believe this came over from the
20 bank regulators. What authority do we have to
21 include foreign governments and sovereign wealth
22 funds? Section 23.150 of the proposed rule

1 expands the statutory definition to include,
2 quote, "Any government or any financial country,
3 or any political subdivision, agency, or
4 instrumentality thereof." What is our statutory
5 hook for expanding that definition?

6 MR. LAWTON: I think the concept is that
7 4s says that you have to have set margin
8 requirements that ensure the safety and soundness
9 of the swap dealer, major swap participant and are
10 appropriate to the risk posed. And so, I think
11 the idea was that such entities seem to pose risks
12 that are more along the lines of the risks posed
13 by a financial entity as compared to the risk
14 posed by a non- financial entity.

15 COMMISSIONER O'MALIA: I appreciate the
16 purity argument, but do you think you're going to
17 actually be able to regulate financial activities
18 of foreign governments?

19 MR. RADHAKRISHNAN: We can try.

20 CHAIRMAN GENSLER: It's just the margin
21 that the bank has to collect.

22 MR. RADHAKRISHNAN: That's right. So,

1 our hook is on to the --

2 COMMISSIONER O'MALIA: And how are you
3 going to enforce that?

4 MR. RADHAKRISHNAN: We'll enforce it
5 against our registrants.

6 COMMISSIONER O'MALIA: And what happens
7 when they can't get it?

8 MR. RADHAKRISHNAN: Our registrants?
9 Then we'll refer it to enforcement for appropriate
10 action.

11 COMMISSIONER O'MALIA: Let me ask you,
12 on the issue of one-way margining, what impact
13 will that have in bankruptcy? If a bank fails,
14 and I am obviously reminded that there was Lehman
15 and Bear that failed that wasn't an end-user that
16 failed that brought the entire financial system.
17 But what happens in bankruptcy under that
18 scenario?

19 MR. LAWTON: Well, I think that means
20 the end- user is going to have to have a claim
21 against the bankrupt entity, whereas if they had
22 received the variation, they would have it. I

1 don't know whether there might be any kind of fall
2 back provisions in that. There probably wouldn't,
3 but I can't really speak to that.

4 COMMISSIONER O'MALIA: Buyer beware?

5 MR. RADHAKRISHNAN: Sort of, yeah.

6 COMMISSIONER O'MALIA: Do you think that
7 provides adequate coverage of our overall
8 financial system?

9 MR. RADHAKRISHNAN: I guess it's a
10 function of who we believe poses greater risk,
11 because if margin goes towards the banks, then the
12 thinking is, from our colleagues in the prudential
13 entities, they'll be more secure. And the chance
14 of them getting into trouble would be less.

15 COMMISSIONER O'MALIA: I don't have any
16 further questions.

17 CHAIRMAN GENSLER: I think that the last
18 question I have, and Commissioner Dunn focused on
19 it, is one that we'd be enormously grateful for
20 the public to comment on is whether two-way
21 margining is appropriate to protect, in essence,
22 the financial entities as well as the swap

1 dealers, and that is a really important one. We
2 included rule text in case. I mean, it's right
3 there.

4 I think I'm going to ask for two
5 unanimous consents. One unanimous consent is just
6 to have a question so that we would retain the
7 flexibility similar to what the prudential
8 regulators do to permit portfolio margining of
9 swaps, executed prior to the effective date, given
10 the possibility that that might be more flexible
11 in the end.

12 Not hearing objection, you'll find the
13 right language in which to do that.

14 MR. RADHAKRISHNAN: We'll find the
15 language, and we'll also make sure that they can't
16 pick and choose.

17 CHAIRMAN GENSLER: And the other one is,
18 I'm picking upon Commissioner O'Malia's question.
19 I think if I could ask unanimous consent that you
20 find the right words of the question on 716
21 push-outs, that what market participants think is
22 appropriate for any transition that might come as

1 somebody, in essence, moves from the prudential
2 regulators' margining standards to our margining
3 standards. Just anything that people on that
4 transition.

5 COMMISSIONER O'MALIA: Can we also ask
6 whether it's appropriate for the end-users to see
7 the valuation and collateral models?

8 CHAIRMAN GENSLER: As amended, a
9 unanimous consent on two issues. They might be in
10 different parts of the document, yeah.

11 COMMISSIONER O'MALIA: Thank you very
12 much.

13 CHAIRMAN GENSLER: Not hearing any
14 objections, I guess we're adding three or four
15 questions.

16 I think there are no further questions,
17 Mr. Stawick.

18 MR. STAWICK: Commissioner O'Malia?

19 COMMISSIONER O'MALIA: No.

20 MR. STAWICK: Commissioner O'Malia, no.
21 Commissioner Chilton?

22 COMMISSIONER CHILTON: Aye.

1 MR. STAWICK: Commissioner Chilton, aye.

2 Commissioner Sommers?

3 COMMISSIONER SOMMERS: Aye.

4 MR. STAWICK: Commissioner Sommers, aye.

5 Commissioner Dunn?

6 COMMISSIONER DUNN: Aye.

7 MR. STAWICK: Commissioner Dunn, aye.

8 Mr. Chairman?

9 CHAIRMAN GENSLER: Aye.

10 MR. STAWICK: Mr. Chairman, aye. Mr.

11 Chairman, on this question, the yeas are four, the

12 nays are one.

13 CHAIRMAN GENSLER: I thank you, Mr.

14 Stawick. I thank the staff. The ayes having it,

15 a majority will be sending it along.

16 I'm supposed to ask unanimous consent to

17 allow staff to make technical corrections, I

18 guess, because we have four or five things they

19 have to get at.

20 Not hearing any objections to that,

21 you'll be able to make some corrections.

22 In terms of moving forward, as you all

1 know, we had identified 30 topic areas for
2 rulemakings. I think with today's, we're 28 and a
3 half topics or something because we have to do the
4 other side, the peanut butter that goes with the
5 jelly, so to speak, capital with margin.

6 We're also hopeful in the next several
7 weeks to move forward with the SEC on the joint
8 rule on product definitions, which then other than
9 a Volker rule, which is sort of on a different
10 time path because Congress put it on a different
11 time path, would really largely complete our
12 proposal phase.

13 It's this Chairman's hope that we do
14 that in the next few weeks.

15 MR. RADHAKRISHNAN: Actually, there's
16 two more, conforming part one.

17 CHAIRMAN GENSLER: There's two other
18 rules. I thank you, Ananda. There's conforming
19 part one, which we scheduled for today, but just
20 with some commissioner travels and so forth, we
21 decided we'll probably be taking up, and also, the
22 segregation of cleared swaps. We're working

1 further on testing and supervision. I don't know
2 that that will be in April. And that's a really
3 important rule. I know many commissioners are
4 weighing in with staff, and so I'm just being
5 realistic. That's probably a little bit more time
6 on the testing and supervision. But on the four
7 product definitions, capital, the conforming rule,
8 which was largely ready for today, and the cleared
9 swap segregation, it's the hope to do those in the
10 next several weeks. I know that you all,
11 Commissioner Sommers and Commissioner O'Malia,
12 much deserved family vacations, I guess next week.

13 I think we're trying to schedule
14 something for the week that you're coming back
15 because it would line up with the SEC on the same
16 day. The 27th we're thinking about possibly doing
17 it. But we're going to work with the SEC if we
18 can get a few more days maybe.

19 So with that, and if there's not any
20 other Commission business, I'll entertain a motion
21 to adjourn the meeting.

22 COMMISSIONER SOMMERS: So moved.

1 COMMISSIONER O'MALIA: Second.

2 CHAIRMAN GENSLER: All in favor?

3 COMMISSIONERS: Aye.

4 CHAIRMAN GENSLER: Thank you again to
5 the team.

6 (Whereupon, at 10:52 a.m., the
7 PROCEEDINGS were adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

DISTRICT OF COLUMBIA

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

Notary Public, in and for the District of Columbia

My Commission Expires: May 31, 2014