

Capital Reporting Company  
Technical Advisory Committee Meeting 07-26-2012

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COMMODITY FUTURES TRADING COMMISSION  
TECHNICAL ADVISORY COMMITTEE MEETING

Thursday, July 26, 2012

10:00 a.m.

Commodity Futures Trading Commission

1155 21st Street, N.W.

Washington, D.C. 20581

(202) 418-5419

Reported by: Erick McNair,

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

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3 CFTC PRESENT:

4 SCOTT D. O'MALIA, Commissioner, TAC Chairman

5 GARY GENSLER, Chairman

6 BART CHILTON, Commissioner

7

8 PRESENTERS:

9 GARY BARNETT

10 CHRIS HEYMEYER

11 BRYAN DURKIN

12 MICHAEL DAWLEY

13 GERRY CORCORAN

14 ALUN GREEN

15 CHRISTOPHER SCHELLHORN

16 STEVE HURST

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

2 COMMISSIONER O'MALIA: Good morning. It's  
3 10:00. I'd like to get started.

4 Well, thank you, everyone, for coming. I  
5 would like to thank the TAC members for their  
6 willingness to attend on short notice. This meeting  
7 has not been on the calendars long, and I know you have  
8 had to work to make arrangements to be here. I'm  
9 thankful for that. I know we have a number of people  
10 on the phone as well, TAC members and Commissioner  
11 Chilton as well.

12 And I want to thank the presenters. These  
13 are experts representing different aspects of the  
14 industry. They are going to provide us some thoughts  
15 and ideas about how we develop a technology solution  
16 going forward, and so I appreciate their rearranging  
17 their own schedules to be here today and to put  
18 together some thoughtful presentations.

19 We obviously want to get to the bottom of  
20 what happened. The Commission is investigating both MF  
21 Global, and we are pursuing legal action against  
22 Peregrine, but this group here today can help us

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1 develop technology solutions that will protect customer  
2 funds from fraud and misappropriation.

3           To state that the meltdown of the two Futures  
4 Commission merchants within the last 10 months has  
5 shaken public confidence is an understatement. The  
6 actions taken by these two firms are a complete and  
7 total betrayal of the public trust and undoubtedly  
8 undermine investor confidence so much that an immediate  
9 and comprehensive overhaul of the customer protection  
10 safeguards is required.

11           Since the failure of MF Global in October  
12 2011, the Commission staff has been working on multiple  
13 rule changes to increase oversight reporting and  
14 compliance among the FCM community. I support the  
15 reforms that will increase transparency, disclosure,  
16 and independent verification of customer funds, as well  
17 as subject FCM business practices to a higher level of  
18 public scrutiny. And I have kind of laid these out in a  
19 speech I gave back in January in New York Law School.

20           In addition, I support reforming the  
21 Bankruptcy Code to ensure that the protection of  
22 customer money in court matches the rhetoric and

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1 promises found in press releases issued recently.  
2 However, the reforms currently under consideration by  
3 the Commission so far fail to close the existing  
4 regulatory gap that allows firms to self-report status,  
5 balance, and location of customer funds.

6           In my opinion, it is imperative that the  
7 industry develop a technology solution that can verify  
8 customer balances held by FCM's custodial banks and the  
9 clearinghouses. This system must be fully automated to  
10 draw feeds directly from relevant entities to compare  
11 balances. If balances do not match, then an automated  
12 alert ought to be sent to the appropriate self-  
13 regulatory organization and the Commission. The  
14 solution must be 100 percent industry funded and  
15 maintained and overseen by the Commission and the SROs.

16           I have called this emergency meeting for the  
17 expert witnesses to share their opinion about the  
18 feasibility of developing such a technology solution as  
19 well as considering other solutions that can verify  
20 customer funds and where they are located.

21           I hope the TAC members will not hesitate to  
22 offer their suggestions, thoughts, and opinions

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1 regarding today's solutions. Today's discussion will  
2 be in two parts. First, we will hear from our  
3 panelists, eight of them, and the second half of the  
4 day will be spent discussing the solutions. We are  
5 going to try to get everybody's presentations in in the  
6 morning, and then come back and kind of go over them.

7           We will begin with our Director of Division  
8 of Swap Dealer and Intermediary Oversight, Gary  
9 Barnett, who will provide the overview of the draft  
10 rules that the Commission is considering today. After  
11 Mr. Barnett, we will hear from Mr. Hehmeyer, Chairman  
12 of the Board of the National Futures Association, to  
13 present the solutions proposed by NFA to protect  
14 customer funds. We were going to go to Bryan Durkin --  
15 he has missed his flight and will be here later -- from  
16 CME.

17           Then, we will go to the two FCM  
18 representatives, Gerry Corcoran with R.J. O'Brien and  
19 Mike Dawley, Managing Director at Goldman Sachs. Then,  
20 we will go to our technology providers, Chris  
21 Schellhorn, President of Capital Confirmation, and Alun  
22 Green, General Manager of Capital Markets for SunGard

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1 about the feasibility of developing a technology  
2 solution that will make completely transparent to  
3 regulators the flow of customer money. Finally, we  
4 will hear from Steve Hurst of -- CEO of Merchants Data  
5 Repository, who has proposed a third party utility  
6 segregation model for our consideration.

7 I fully expect today's discussion to help the  
8 Commission make critical decisions about technology-  
9 based fraud prevention systems, understanding what is  
10 needed, and how soon it can be implemented, and who  
11 will be connected are but a few of the questions I have  
12 for the panelists today. I am also open to other  
13 suggestions to place customer funds outside of the FCM.  
14 But regardless of where we put the money, there must be  
15 a technology solution that will give customers  
16 certainty that their money is safe each and every day.

17 This is being -- this discussion is being --  
18 not webcast, it is over a phone line, so when you  
19 introduce yourself, or when you have a comment, please  
20 remember to introduce who you are, so people can follow  
21 the dialogue over the phone. I think this is being --  
22 is it being recorded, and then it will be posted later,



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1 but it is not being live webcast. Tape delay I guess  
2 for language. No, that's not true.

3 We will begin -- oh, let me turn -- I know  
4 Chairman Gensler is going to join us a little bit  
5 later. We do have Commissioner Chilton on the phone,  
6 and I turn it over to him to make his opening remarks.

7 COMMISSIONER CHILTON: Thanks, Mr. Chairman.  
8 I will be very brief, and I will be on listen-only most  
9 of the morning. I will let you all know if I have  
10 questions.

11 But thanks for everybody taking the time out  
12 of your schedule, and thanks particularly to  
13 Commissioner O'Malia for -- him and his staff for  
14 organizing this meeting in such short order. And I  
15 agree with everything that you said, Scott, just to a  
16 tee. Everything you said I think is right on the  
17 market.

18 It is clear that some of these futures firm  
19 fraudsters can cost a lot of people a lot of money when  
20 they put their minds to it. And we all need to -- us  
21 at the CFTC included -- need to do a much better job  
22 and have the right tools to protect customer funds. I

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1 have talked about it a lot, but I still think we need  
2 regular and robust deep data dives -- and that is  
3 really what you are talking about, Scott -- to make  
4 sure the customers' money is where it is supposed to be  
5 24/7/365.

6 I also think -- and this isn't a technology  
7 thing, but I think we need an insurance fund, like the  
8 securities and banking worlds already have, as a  
9 backstop for customers. Yesterday people said, "Well,  
10 that is going to cost a lot of money." Well, that  
11 shouldn't be the end of the conversation. How much  
12 money is it going to cost? And do I care, as a  
13 regulator, if consumers or customers are protected if  
14 it costs somebody some money? I mean, no, I want them  
15 protected. So I think we need more work on an  
16 insurance fund.

17 And we need to make sure that we can't have  
18 the wool pulled over our eyes by somebody with Photo  
19 Shop and a bottle of Wite-out, for gosh sakes. In most  
20 sports teams, like when we watch the Olympics, you  
21 know, a fake is a good thing, like with a ball or  
22 something, at least for the offensive team, but not so

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1 much for the defense, and really not so much for us,  
2 for us regulators. We have to be able to see around  
3 corners. And, sadly, we have to be very, very  
4 suspicious.

5           We really need an Olympic caliber regulatory  
6 oversight regime. Much of what is needed comes down to  
7 technology, and, thus, the meeting today. We need the  
8 technology to do those deep data dives and to make sure  
9 we are not being faked out. And we need good guys who  
10 are better at using the technology than are the bad  
11 guys.

12           So thank you again for taking time for  
13 everybody to participate in the TAC. And thank you  
14 again, Scott, for your leadership. Thanks.

15           COMMISSIONER O'MALIA: Thank you,  
16 Commissioner Chilton. Again, we will be joined by  
17 Chairman Gensler later, and he can make his remarks  
18 then.

19           Let's get started. We'll go -- we are going  
20 to start with Gary Barnett, Director of DSIO here at  
21 the Commission, largely responsible for assembling the  
22 regulatory reform solutions begun post MF Global, and I

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1 think accelerated now that we have had this second  
2 problem. After that, we are going to go to Mr. Durkin,  
3 but -- no, Chris Hehmeyer, who is our TAC -- Chris is  
4 over here. So you're next. Gary?

5 MR. BARNETT: Okay. Thank you, Commissioner  
6 O'Malia. As you said, we are working on multiple rule  
7 modifications to enhance customer protection, and I  
8 will provide you with an overview of where we are so  
9 far.

10 To kind of categorize the changes that we are  
11 working on, first, we are trying to incorporate or  
12 federalize the NFA's recent Section 16. We think that  
13 it has some important changes to it that we ought to  
14 adopt as well. We were actually involved in  
15 discussions. We greatly appreciate the dialogue we had  
16 with them, and we think that the result they got --  
17 Section 16 is very helpful.

18 In part, Section 16 -- and I'll just touch on  
19 it, so I don't take away from NFA's discussion later,  
20 but so you understand where we're going categorically,  
21 it ends the Part 30 alternative method. It requires  
22 additional reports, things like daily computations of

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1 seg and secured, and twice monthly detailed reporting  
2 regarding cash and investment of customer funds. And  
3 then, there are some data points on -- about the  
4 company itself, leverage and prop trading, and so on.

5           It requires policies and procedures and  
6 controls around disbursements from seg and secured, and  
7 these policies and procedures can cover things such as  
8 separation of duties and training. It is open to that.

9           In addition -- and I think this is a very  
10 powerful regulatory tool -- the rule will require the  
11 FCM to engage in an analysis, which they will have to  
12 document. It will be helpful to the regulators, both  
13 the SRO and the Commission, their analysis of the  
14 amount of access they need to maintain in order to  
15 reasonably ensure that they will remain in seg and  
16 secured compliance at all times.

17           And with the daily reporting, along with the  
18 analysis of the retained interest, they should have  
19 given their business risk profile. It would be very  
20 helpful to us.

21           And then, the rule's key feature in terms of  
22 concerns about disbursement or withdrawals on any day

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1 aggregating more than 25 percent of the targeted access  
2 have to be approved by senior management and reported  
3 to the SRO, to NFA, along -- and to us, along with a  
4 certification they remain in compliance with seg and  
5 secured requirements. And we want to bring those  
6 elements into our rule package.

7           In addition, we want the SROs and ourselves  
8 to have direct read-only access to FCM bank and  
9 custodial accounts for customer funds 24/7 and without  
10 FCM permission. So we think that this ability to tap  
11 into the core information may be important to this  
12 project that the TAC is looking at.

13           We also want more transparency to regulators  
14 about the FCM's operations. We want more trend and  
15 risk information. We will be requiring reporting of  
16 material changes in the business or relevant affiliates  
17 that could have a material adverse effect on the FCM.  
18 And that is going to be -- require a balance, and we  
19 are working on it, because we know that we have seen  
20 examples where the corporate structure of an FCM, there  
21 is not a lot between the affiliates and what is going  
22 on. An affiliate has a very significant and direct

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1 effect on the FCM.

2           We also know that some of you have a plethora  
3 of affiliates, and some of them are no so relevant. So  
4 finding the right balance and getting that right is  
5 important, and we are looking at that.

6           We are looking for more transparency to  
7 customers about their funds and the counterparties they  
8 use, and even the FCM itself. We think customers  
9 should have even greater access to information about  
10 how their assets are held and with whom, and we think  
11 they should have more information about the business of  
12 the FCM that -- information about the elements of the  
13 business that can create risk to the customers.

14           And, you know, one thought that we have  
15 talked about here internally quite a bit is that  
16 investors who go to mutual funds, or they invest in a  
17 company, they get a lot of information about the  
18 material risks they are taking on when they put their  
19 funds into the entity. We think that customers who  
20 entrust their funds to an FCM have -- should have  
21 similar information, so that they can make an  
22 evaluation of the FCM they are choosing.

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1           And the corollary, then, to this is that if  
2 the oversight has to take into account risks and  
3 controls and policies and procedures, and so on, take  
4 more information into account, then so must the  
5 examination process follow. So we are working on  
6 various initiatives to enhance our examination process,  
7 and more information about those initiatives in terms  
8 of the examination process will come out in the near  
9 future.

10           And that is my summary, Mr. O'Malia,  
11 Commissioner O'Malia.

12           COMMISSIONER O'MALIA: Great. Thank you. I  
13 think from the -- for the technology aspect of this --  
14 and this is why we're here -- you mentioned giving SROs  
15 and CFTC direct electronic read-only access for FCM  
16 bank and custodial accounts, for customer funds, 24/7  
17 without FCM permission.

18           MR. BARNETT: Yes, sir.

19           COMMISSIONER O'MALIA: What does that mean  
20 exactly? How will we do that? What do you have  
21 envisioned? And obviously we have assembled this  
22 group, and you have laid out something similar to what



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1 I am thinking about, but we want to tackle it. Do you  
2 have an idea in mind that maybe we can further discuss  
3 here?

4 MR. BARNETT: Sure. Yes. Our idea is,  
5 without the benefit of this group, ours is starting  
6 with the acknowledgments we get from the bank about the  
7 account acknowledgements, about the account is a seg  
8 account or a secured account, so on and so forth.

9 COMMISSIONER O'MALIA: And how do we receive  
10 that today?

11 MR. BARNETT: How we receive it currently is  
12 it is received at the SRO, and it is sometimes held by  
13 the FCM. So, obviously, we will have to have that  
14 directly delivered to us, and then we will have to call  
15 to confirm that it was in fact sent to us by the  
16 depository. So what we currently do versus what we  
17 will do are different.

18 COMMISSIONER O'MALIA: What we receive today,  
19 can it be faxed? Is it emailed? How do we receive it  
20 today? Does it populate any of our systems? What is  
21 our technology solution? What do we have in terms of  
22 technology? What is our technology baseline, if you

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1 will, and where do we have to be?

2 MR. BARNETT: We are talking about getting it  
3 through the Windjammer system. But, again, we -- you  
4 know, in terms of legal obligation to deliver it versus  
5 the process of delivering it, how we will deliver it  
6 has not been nailed down.

7 So if there are ways to improve on how we do  
8 it, we do know based on recent experience that we need  
9 it delivered directly to us from the bank. We know  
10 that we need to call back to confirm that it came from  
11 the bank. But the methodology -- you know, whether it's  
12 an email, whether it's a fax, we haven't nailed that  
13 down. So we are open to discussion or improvement in  
14 that regard.

15 COMMISSIONER O'MALIA: Do you want to just  
16 briefly state what Windjammer is?

17 MR. BARNETT: Yes. It is a system that is up  
18 that FCMs submit filings to us through that system.  
19 It's an electronic system and --

20 COMMISSIONER O'MALIA: Run by NFA, built by  
21 NFA, correct?

22 MR. BARNETT: Yes.

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1 COMMISSIONER O'MALIA: And CME?

2 MR. BARNETT: I could use some help from one  
3 of the FCMs on that, but yes, I think that's right.

4 COMMISSIONER O'MALIA: So your vision is --

5 MR. BARNETT: Yes. So to finish the thought,  
6 then, is that the bank would have its -- would have the  
7 depositor's consent right in that acknowledgement, and  
8 it would -- and the bank would be agreeing right then  
9 and there that going forward we would have --

10 COMMISSIONER O'MALIA: The depositor in this  
11 case, is it the FCM or the customer?

12 MR. BARNETT: It's the FCM on behalf of the  
13 customer. So around those accounts, the FCM would be  
14 agreeing, and the bank would be agreeing at that moment  
15 in time, locking in the agreement that we would have  
16 access without further subsequent permission, that we  
17 would have that access 24/7 going forward. And then,  
18 we want it electronically as well.

19 COMMISSIONER O'MALIA: Having a bank -- you  
20 have kind of -- I want to be clear about this. You  
21 have kind of stated two things -- one, that we would  
22 have 24/7 access, which it would imply that we could go

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1 in and check balances. You have also said they would  
2 have to, you know, push essentially data to us. What  
3 is your preference? Do you want to have the capacity  
4 to look and survey each and every account? Or do you  
5 want periodic regular reports?

6 MR. BARNETT: No, no, no. We want online  
7 access. We want to basically be able to -- give us our  
8 own password and let us go online and go into the --  
9 and look at the account balance.

10 COMMISSIONER O'MALIA: How many people will  
11 it take to check using our own password? I mean, I  
12 have a bank account. I can go check it, you know,  
13 frequently. I forget my password, and I get locked out.  
14 It takes time. Where are we going to get the people to  
15 go checking balances? And if we are going to check one  
16 FCM with one -- versus one custodial bank, how many  
17 customers and how many accounts are there out there?  
18 Can we feasibly do that?

19 MR. BARNETT: No, you are absolutely right.  
20 What you are implying in your question is absolutely  
21 right. You remember in a recent case with an FCM that  
22 came under stress and was happily, you know, resolved

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1 in a good way, had to transfer the business. We were  
2 watching the seg and secured balances on a real-time  
3 basis, and it really took a single person to just track  
4 all of the things that we were going on while we were  
5 in that sort of stress period of moving that entity.

6           So it is very -- it would be labor intensive  
7 for an individual or a staff to be sitting there  
8 watching those numbers or watching for great variances.  
9 So I think what is implied in your question is right,  
10 that it would take -- to watch all FCMS and watching  
11 all transactions, and when you hear probably from these  
12 -- your participants, the numbers of accounts and  
13 things that are there, I mean, it would be -- to the  
14 extent that you can cover some of that electronically  
15 or all of it electronically would be fantastic. But it  
16 would be very labor intensive.

17           COMMISSIONER O'MALIA: Yes. Cliff, I would  
18 like to recognize you. But I have broken my own rule  
19 already -- we are going to hear from panelists, and  
20 then we are going to take questions. But I think it's  
21 important we - - you know, we flesh out exactly -- what  
22 is the baseline the Commission is looking for? So

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1 that's why I have probed a little bit. I think it --

2 MR. LEWIS: I'm going to go longer, but I  
3 think

4 --

5 COMMISSIONER O'MALIA: Yes.

6 MR. LEWIS: -- how would this work for --  
7 sorry. How would this work with respect to non-cash?  
8 You know, in this interest rate environment is one  
9 thing, but for many institutions they won't put up  
10 cash. And to think you can get -- I mean, it won't  
11 work, just to be clear. What you're proposing can't be  
12 done.

13 MR. BARNETT: Okay.

14 MR. LEWIS: You can't get real-time  
15 information on non-cash. And so --

16 MR. BARNETT: What do you propose? What do  
17 you suggest for confirmation?

18 MR. LEWIS: Longer discussion. But I'm just  
19 saying that what you --

20 MR. BARNETT: Okay.

21 MR. LEWIS: -- I don't want to break the  
22 Commissioner's rhythm on this, but sorry.

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1           MR. BARNETT: Well, we are totally open to --  
2 I mean, that is -- you know, this Committee -- and we  
3 will have a rule package that will be proposed, and we  
4 will be looking for comments and suggestions. I mean,  
5 I think it is in everybody's interest to find ways to  
6 enhance every element of this, and so we are totally  
7 open to it.

8           So if it doesn't work, great to know it. And  
9 if there are better ways, then it is great to hear that  
10 as well. And we will, you know, run down any options  
11 that we can, and we will -- you know, we will take all  
12 things into account. So --

13           COMMISSIONER O'MALIA: Do you have a sense of  
14 how many banks -- custodial arrangements there are?  
15 Where is the money today? And who will we have to  
16 build out this network to? What is the extent of this  
17 reporting that we will need?

18           MR. BARNETT: Yes. And obviously our  
19 examinations folks, you know, Kevin Pacauley and so on,  
20 can give you much greater detail. But some of these --  
21 and your folks about the table. I mean, but the number  
22 of accounts and -- can be very, very significant. The

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1 locations, you know, custodial accounts and the number  
2 of bank accounts can be very large. I couldn't give  
3 you a number off the top of my head without checking  
4 back with our folks, but it is a very large number.

5 COMMISSIONER O'MALIA: Let's keep the  
6 presentations going. Thank you, Gary.

7 Chris Hehmeyer.

8 MR. HEHMEYER: Thank you, sir. Thank you  
9 very much, Mr. Chairman. I do come here today wearing  
10 a couple of hats, but mostly with my hat on as Chairman  
11 of the Board of the NFA. And a little bit that's what  
12 has been said so far, I would like to put that a little  
13 bit into some perspective, which I think NFA and from  
14 my tier we can do.

15 And, yes, I have -- I also have an  
16 affiliation. I am Non-Executive Vice Chairman with what  
17 is now Knight, and was Penson, so I also would like to  
18 say that in addition to the trading I also have an  
19 appreciation for the complexities for the FCMs. Having  
20 said that, I would like to say that what smoked out the  
21 fraud at Peregrine in this instance was NFA's use of  
22 any confirmation process. And Chris Schellhorn from



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1 Capital Confirmation, LLC is here and can describe  
2 that.

3 And that was in our annual audit of  
4 Peregrine, where we were moving towards an e-  
5 confirmation of what bank balances were. And that's a  
6 relatively simple thing. It's an e-confirmation, just  
7 of a bank balance.

8 And we are going to make it now that to be  
9 any acceptable bank depository that they have to have  
10 this e- confirmation ability. But there are banks out  
11 there that don't have that that are perfectly good seg  
12 locations, but we are working on a rule with the CME  
13 and with the CFTC, and that takes some technical, legal  
14 work to require banks to have e-confirmation for  
15 auditing purposes.

16 Ultimately, where we want to take the e-  
17 confirm process is a daily basis of collecting the seg  
18 information that NFA collects from all of its FCMs  
19 today, and now on a daily basis, clearing FCMs and non-  
20 clearing FCMs. We want to get to a place where -- and  
21 the technology is there, and this is feasible, where we  
22 collect the information from the FCMs about their seg,

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1 and then confirm that online.

2           And I think that that is exactly what Gary is  
3 talking about, but Cliff raises a very good point in  
4 that FCMs are able to put segregated funds, by law, and  
5 certainly able to do it, and they do it every day, in  
6 different types of depositories. Banks are pretty  
7 easy; broker-dealers are maybe a little bit tougher,  
8 but when we start getting into certain FCMs putting  
9 their deposits into term repos or foreign government  
10 debt or 30.7 or in other time zones, and seg -- FCMs  
11 are good seg locations to each other, it starts to get  
12 complicated.

13           And I want to come back to that, but this  
14 idea of what at NFA we call "the big system," but it is  
15 a -- it's basically a -- it's a depository of  
16 segregated funds confirmation system is what it is, a  
17 daily segregated confirmation system. So that we get  
18 the report from the FCMs daily as to where they have  
19 the segregated funds, and then online we confirm those  
20 balances with the depositories. But that is a big,  
21 complicated, hairy project to do.

22           And so let me come back to that for just a

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1 sec, because in the interim -- so that is going from  
2 just an e-confirm at an audit to a big, hairy system  
3 that does all of this online. In the interim, what we  
4 are talking about is a direct view online access, which  
5 is really, Commissioner O'Malia, what you are talking  
6 about is going online and checking a balance every day.

7           So if we've got -- we can spot-check, and,  
8 yes, we're talking about I think three to six people  
9 that would do nothing but in the mornings go online,  
10 check balances, manual process. Takes a lot of time.  
11 You've got to have people involved in all of that, have  
12 some idea of what they are looking for.

13           And so the interim would be this online  
14 process, and we were in the middle of working on this  
15 online process before Peregrine as a result of MF. And  
16 some of those online processes are not going to prevent  
17 what happened at MF, because if there are thousands of  
18 transactions moving back and forth it can be very  
19 difficult to online go on and check a balance, but it  
20 would have caught the Peregrine thing.

21           So we are working -- NFA is working, and  
22 we've got a very good special committee of our outside

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1 directors that was looking for the protection of  
2 customer segregated funds that works with CME, which is  
3 the other DSRO. But we -- and actually this is the SRO  
4 Committee. We have a very good SRO Committee that has  
5 been working on this project and understand the issues.  
6 And this online requirement of requiring the banks --  
7 bank depositories to have online access, we hope to  
8 approve that at our August Board meeting. That will be  
9 coming to the CFTC. And, again, this interim step of  
10 online manual checking bank depositories is a very good  
11 place to start.

12 But it is -- it will be online, but it is  
13 manual. So those doable, in-our-control things, we are  
14 going to do quickly with CFTC and CME and other SROs  
15 that -- the other exchanges and such. So let's talk --  
16 but let's talk for a minute about the big system, if  
17 you will, if we call it that.

18 So, you know, basically what we are talking  
19 about is taking the online system, or the e-confirm  
20 system, and making it a daily collection of this data.  
21 And this is possible, because we have the FCMs today --  
22 clearing and non-clearing -- sending their daily seg

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1 data to NFA every day.

2           So what we want to be able to do is to have  
3 that information come in electronically, and then  
4 confirm it electronically, and that is where it gets  
5 complex. It is pretty easy with a bank. It is the  
6 other time zones -- 30.7, the complexities of that --  
7 which will take some time.

8           And I don't honestly thing, from my tier,  
9 that - - this is a judgment call, but I'm not sure if  
10 the political will was there to spend the money and  
11 scope out this kind of a project at NFA and do this  
12 before the Peregrine thing. But -- and the people I  
13 have talked to, without officially taking a vote or  
14 something, I feel that the will -- and especially now  
15 that we have all focused on this -- I think the will is  
16 there, and I'm sure it is.

17           And I think it is going to take some work to  
18 try to scope out the scale of this project and decide  
19 what we can do first, get it into Gantt charts, how  
20 long that would take, what we can do, what we can't do,  
21 some business requirements, and work of course with the  
22 CME.

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1           Now, you're going to hear a lot of things  
2 today about different solutions -- a custodian, third  
3 party solution, a custodian at an exchange solution.  
4 Those are bigger discussions, and I am, of course, here  
5 to discuss possible other comprehensive solutions. But  
6 the technologies at NFA -- and we have -- we have a  
7 couple of technology things today that -- Trade Pack,  
8 this is in market surveillance, I think it's called  
9 TPMS.

10           We can leverage some of those technologies.  
11 We have this information coming into the organization  
12 today, and online confirmation, and then you can check  
13 with online confirmation for exceptions, patterns,  
14 things like that. And so NFA, I feel, has got this  
15 within our capability. Certainly, it is doable. It is  
16 affordable for the industry. I think we can do this.  
17 It is going to take us a lot of work, and we hope to  
18 try to have the scope of this laid out by our August  
19 Board meeting.

20           It doesn't necessarily change some of these  
21 other ideas that are going to come up, but it can  
22 address getting information from FCMs daily and

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1 confirming as much as possible balances at other good  
2 seg locations.

3           Let me see. Give me one sec here to get  
4 caught up with my notes to see exactly where we are.  
5 Again, I would like to emphasize here that the tricky  
6 part will be working with the depositories, because  
7 they come in different sizes and shapes, money markets.  
8 Frankly, we would have to get the clearinghouses to  
9 agree, but for our members I think that NFA has a very  
10 good position to be able to -- the members are going to  
11 be required to send us the seg every morning, and we  
12 can then confirm it.

13           I would like to also point out one other  
14 thing. And, again, in trying to distinguish between e-  
15 confirm online manual and a big system that does this  
16 in an automated way, those distinctions can get lost in  
17 the wash a little bit in some of these types of  
18 discussions.

19           I also would like to point out the  
20 distinctions between real time. Real time is not going  
21 to be yet. Real time is during the day, and the  
22 exchanges of course do that with positions, pre-trade

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1 for instance, and then immediate, with all of the  
2 positions and the risk systems. That's a little  
3 different than the reporting for the FCMs of this seg  
4 stuff. That for the most part, because of out-trades  
5 and such, doesn't get prepared until the next day. So  
6 really what we are talking about is batch, once a day,  
7 at NFA, this system we're talking about, as opposed to  
8 real time where we are monitoring, because I think you  
9 will hear from some of the FCMs who are here today,  
10 they have thousands of electronic transactions every  
11 day, and NFA is not capable certainly now of monitoring  
12 all of those electronic transactions in and out of seg  
13 funds and the FCM's depositories during the day online.  
14 That would be, you know, very expensive, maybe  
15 somewhere down the road.

16 But this batch of -- basically, it's T plus  
17 one, the next day, which all of the FCMs are preparing  
18 seg statements the next day, and a confirmation of  
19 those deposits is something that is within our grasp.

20 COMMISSIONER O'MALIA: Great. Thank you. I  
21 think you have pointed out two good -- a couple of good  
22 points, several good points about what is -- what NFA



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1 is doing today, what will take longer to complete, the  
2 challenge of it, and integrating all of these pieces.  
3 I think it is important to realize that what we have  
4 here in these two recent meltdowns of the FCMs are two  
5 completely different scenarios, and we are trying to  
6 put together solutions that kind of solve for both.

7           MF Global money was massive amounts of money  
8 was moving at the click of a mouse all over the place,  
9 and, therefore, obviously, you know, the response is a  
10 real- time response. We want to see where this money  
11 is going, because, based on what happened there,  
12 massive amounts of money were in and out on a daily  
13 basis. And we have to solve for that. That was, in  
14 terms of dollar amount, a much larger amount.

15           In regard to Peregrine, it is a -- you know,  
16 a long time, consistent theft or fraud of customer  
17 money that must be addressed in dealing -- obviously,  
18 we are past the days of the Wite-out and everything  
19 else, and moving to an electronic system will solve  
20 that. But we have to think about all scenarios, how we  
21 are going to fix them, and how we are going to solve  
22 for them.

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1           Another point you brought up that I think was  
2 interesting that was not addressed in Gary Barnett's  
3 comments -- and, Gary, I would like to -- maybe if you  
4 could fill in the gap on this one -- what are you  
5 thinking about in terms of an electronic system for  
6 30.7 money? This is obviously foreign futures money,  
7 U.S.

8           customers trading on foreign boards of trade,  
9 trading through an FCM here, but their dollars are  
10 somewhere else. What level of protection can we offer  
11 or tie to enhance the customer protection in that  
12 scenario?

13           MR. BARNETT: All we are thinking at this  
14 point is the same thing with respect to secured funds  
15 that are under the control of the FCM.

16           COMMISSIONER O'MALIA: The domestic FCM.

17           MR. BARNETT: Yes, yes. So if -- you know,  
18 if more than that is possible, then, you know, we  
19 should consider it. But so far the Part 30 system is  
20 not set up in that way. We are talking about getting  
21 rid of the alternative method. But in terms of  
22 monitoring more -- or validating or confirming that

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1 funds are, you know, posted as margin, let's say, at a  
2 foreign exchange or something like that, we don't have  
3 -- we haven't proposed anything in that regard.

4 COMMISSIONER O'MALIA: Okay. And, obviously,  
5 when we get to the FCMs -- and, Mike, that might be --  
6 as a global FCM, something that you would want to  
7 address, or, Gerry, you as well.

8 We were going to go to Bryan. We'll check  
9 his flight status. Let's go to Gerry Corcoran, head of  
10 R.J. O'Brien.

11 COMMISSIONER CHILTON: Hey, Scott?

12 COMMISSIONER O'MALIA: Yes. Commissioner  
13 Chilton.

14 COMMISSIONER CHILTON: I won't be  
15 interrupting - - I apologize for this thing -- but I  
16 did want to mention that, Chris, you did a really good  
17 job of describing, you know, how it could work. And my  
18 only urging is that I know how these things go.

19 You guys will meet in August, and you will  
20 try to set up what you think should be the parameters,  
21 and then you will meet again in November/December.  
22 And, you know, I just urge you to keep urgency in your

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1 mind. It sounds pretty complicated, you know, doable,  
2 but it sounds like it could be something, you know,  
3 that could be done like even next year if we don't put  
4 the pedal to the metal.

5           So I just urge you to, you know, if things  
6 will be out of the headlines -- when things are out of  
7 the headlines, there should not be urgency, and I think  
8 we need to do this. And so I commend you for  
9 everything you said and how you have gone about it, but  
10 I urge you and your members to do the best you can to  
11 put these systems in place and working with us.

12           Thanks very much. I won't keep interrupting,  
13 Scott. Thank you for your patience.

14           COMMISSIONER O'MALIA: We're pleased to have  
15 your comments at any point. So don't hesitate. I  
16 can't help but interrupt, so I would think it would be  
17 difficult for you as well.

18           So, Gerry.

19           MR. CORCORAN: Thank you, Commissioner. I  
20 have a presentation that I think is fairly pertinent to  
21 what we have been talking about today, some real life  
22 examples of the challenges, some of the areas that are

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1 easier than others, and certainly some of the things  
2 that Cliff pointed out. So I am just going to get  
3 started here.

4           First of all, I am not sure, you know, the  
5 group here knows much about R.J. O'Brien, but we have  
6 been around a long, long time, since 1914. I think we  
7 are the oldest FCM in the industry today, a founding  
8 member of the CME, and I have joined in many of these  
9 exchanges that you see up there.

10           We are the largest independence FCM non-  
11 broker - - broker-dealer FCM, and we are the eleventh  
12 largest overall as measured by customer assets. We  
13 have \$400 million of annual revenues, \$4 billion of  
14 assets, including \$3.6 billion of customer assets, and  
15 a capital base of over \$200 million.

16           I have a theme here -- I took it from Reagan  
17 -- "Trust but verify." And I think it's a new era for  
18 the futures industry that we are talking about here,  
19 and transparency is going to be awfully important to  
20 restore the safeguard -- the confidence in the system,  
21 and so I think all FCMs that I know of, and are  
22 participating in the collective voice of the industry,

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1 have agreed and support 100 percent the ability for the  
2 regulators to have transparency into the balances not  
3 only in our bank accounts but in custodian accounts and  
4 exchange balances as well.

5           Along with that transparency, there is other  
6 checks and balances that the industry has worked on  
7 very, very hard. The FIA has worked, in conjunction  
8 with the Commission and the NFA, to put together the  
9 NFA financial requirement, Section 16, which becomes  
10 effective September 1st, which puts in a whole new  
11 level of protections for customers, and transparency as  
12 well to the regulators.

13           One of the points that I think is coming out  
14 as this process evolves is that, you know, size  
15 matters. And what I mean about that is, as we continue  
16 to require FCMs to report on a daily basis, it just  
17 doesn't seem likely or possible that the small FCM can  
18 exist in the environment of the requirement of the  
19 separation of duties that are going to be required to  
20 mitigate risk.

21           And so I think at some point the Commission  
22 will have to consider the size of an FCM, and are they

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1 capable and have the financial resources to put in the  
2 internal controls on the separation of duties to  
3 conduct business the way we all are leaning towards.

4           So I want to talk about the complexities of  
5 the asset verification process. This is a little  
6 technical, a little granular. My background is I am a  
7 CPA. I was a CFO at R.J. O'Brien for many, many years.  
8 I understand in great depth the segregation of customer  
9 assets, and I understand where they are placed. And so  
10 I am going to walk you through here -- a segregation  
11 statement of R.J. O'Brien -- and look at the different  
12 seg locations that we have to verify.

13           The bottom line of this is that this can all  
14 be done, but it is challenging, it is not necessarily  
15 real time in every instance, but it can definitely  
16 close the window on fraud by working on a T1 basis.

17           So, first of all, the segregated statement is  
18 made up of two components. The first component is the  
19 actual liabilities that we have to the customers. This  
20 is not where the -- this is not where the assets are  
21 located. This is the assets that we hold on behalf of  
22 our customers. And, in this case, on this seg

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1 statement, RJO was holding just short of \$3.6 billion  
2 of customer assets.

3           And you can see they are in a number of  
4 different categories -- cash, securities, the net  
5 unrealized gain or loss in the marketplace, option  
6 values, and some other accounting matters. I mean,  
7 this part of the seg statement hasn't discussed too  
8 much, but it is important as well, because if a  
9 fraudulent FCM is understating liabilities, they can  
10 also understate their assets then as well.

11           So we can't overlook the importance of making  
12 sure the regulators are certain that the seg  
13 requirements are accurate, because, if they are  
14 understated, it allows a fraudulent FCM to conceal  
15 losses.

16           So I am going to walk through the seg  
17 statement here at R.J. O'Brien. You can see in the top  
18 right I've got a little green light. This is the areas  
19 that I think are really workable, that people have  
20 talked about. So this is -- in our case, we have  
21 highlighted cash that we have at bank accounts. On  
22 this date, we had about a billion dollars of customer



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1 cash. Okay? And if you look to your -- to the right  
2 of the screen, you will see that our cash is located in  
3 nine different banking relationships and 34 actual  
4 accounts.

5           So this is -- these are the bank accounts  
6 that the regulators could have real time access to. If  
7 there was something going on that they wanted to look  
8 into, they could see it at any time.

9           In terms of tying it out to the seg  
10 statement, they would really work on a T1 basis. What  
11 was the ending date balance? And did it compare well  
12 with the seg statement? Pretty easy. I think it is  
13 all doable, a lot of work, shouldn't understate the  
14 work that is required to get it done from a technology  
15 standpoint, but the technology exists today and it can  
16 be done.

17           The next category is a little different. It  
18 is the securities representing investments of customer  
19 funds. This is different, and this is what I think  
20 Cliff was alluding to. These are held -- in RJO's  
21 case, three custodial accounts. They are containing  
22 permissible investments pursuant to CFTC Rule 1.25.

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1           There is not real-time access to this data  
2 necessarily. This is data that you would get on a T1  
3 basis, end of day, at some point after the close of  
4 business. Most of the custodians post mark-to-market  
5 valuations pretty quickly these days. You don't have  
6 to wait until the next morning. So that's a green  
7 light as well, but it's not necessarily real time.

8           The next category are securities held for  
9 particular customers or option customers in lieu of  
10 cash, and these can be deposited in three different  
11 locations. They can be in bank accounts. They can be  
12 posted at the exchanges. In our case, they can be  
13 posted with other FCMs that clear other markets for us.

14           So, again, for us, it is comprised of  
15 customer- owned securities, which reside at three  
16 counterparties, which are comprised of banks, custodial  
17 accounts, or exchanges. Again, this one is a yellow  
18 light, because it is spread over a number of allowable  
19 seg locations. And the regulators would have a number  
20 of places to work with to tie out balances daily.

21           You can also see at the bottom of the  
22 schedule I've got a running total of how many accounts

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1 would need to be verified at R.J. O'Brien. So up to  
2 this point, we are at 40. This is a yellow light item.

3           The next schedule is cash at exchanges. So  
4 this is -- contains exchange plus cash and permissible  
5 investments of customer segregated funds. For RJO, it  
6 is at the CME and the ICE exchanges. I don't think we  
7 will have any trouble with the exchanges providing  
8 real-time access to our accounts. In some cases, the  
9 exchanges, the DSROs, they have access to that, so that  
10 won't be too difficult. And we are up to 42 accounts.

11           Then, you move into the actual settlement  
12 from clearing organizations. This is an asset or a  
13 liability, depending on the OTE of the customer assets.  
14 This one is -- we red light it a little bit because it  
15 is complicated, and it is complicated because there is  
16 a reconciliation process that occurs in the back office  
17 on trades.

18           Let me give you an example. The CME may say  
19 RJO has an \$8 million asset. We may say we have a \$9  
20 million asset. And what is the difference? Well, it's  
21 an out trade. We still have out trades. You could  
22 still have a problem where a trade didn't hit an

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1 account on a given basis, or whatever a back office  
2 process is.

3           So actually for a regulator to tie it out, if  
4 it doesn't tie out, they are going to need access to  
5 the FCM's balancing statements as we call it, the  
6 jargon in the industry. So they will have to have  
7 access to a balancing statement, and they will have to  
8 understand the balancing statement to review it and  
9 ascertain that the balancing statement itself isn't  
10 fraudulent.

11           So this gets a little more complicated. It's  
12 not as simple. And it would take some more work, and  
13 it probably isn't -- the initial element of  
14 verification could be automated, but there will  
15 absolutely have to be human intervention to review  
16 reconciliation process. And we are up to 44 accounts  
17 now.

18           The next category is just the option value.  
19 Long and short, that is pretty easily confirmed with  
20 the exchanges. You could do real time, don't think  
21 it's really necessary. T1 is probably okay in terms of  
22 monitoring and verification, and we are up to 47

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1 accounts.

2           We have our net liquidating equity. This is  
3 at other FCMs. In our case, we clear the Kansas City  
4 and Minneapolis markets through another FCM. That can  
5 be verified as well, up to 48 accounts. So, you know,  
6 what is it going to take, you know? Just for RJO, we  
7 have 48 accounts in the seg domain. If you take into -  
8 - the secured accounts, 30.7 accounts, you are probably  
9 looking at 70 accounts with banks carrying brokers and  
10 exchanges.

11           And I think if you try to extrapolate that to  
12 the industry where there is 116 registered FCMs, there  
13 is well over a thousand accounts that would have to be  
14 verified daily, some of which can be done  
15 electronically and matched off with computers and  
16 technology. But more likely there will be periods in  
17 both banks and the carrying brokers and the  
18 reconciliations with the exchanges where there will be  
19 human -- a need for human review of reconciliations of  
20 balancing statements.

21           So the bottom line here is that, you know, it  
22 can be done. It is going to take a lot of technology

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1 and integration to make it efficient. And I think  
2 that, you know, we shouldn't be in any way held back  
3 from doing this thing quickly. And I -- and, you know,  
4 it can be done by segments. Let's get the cash nailed  
5 down first. Then, let's work with the exchanges on, you  
6 know, OTE.

7 I don't think we should wait for the big  
8 bang, in other words. Let's not wait until everything  
9 is perfect. Let's start eliminating the risk as  
10 quickly as possible, and that, of course, is in play  
11 already with the independent verification of the daily  
12 bank statements.

13 So that concludes my presentation. I hope  
14 you found it meaningful in light of what we're talking  
15 about today.

16 COMMISSIONER O'MALIA: Well, it was  
17 extraordinarily helpful to understand and just walk  
18 through that balance sheet and give us some perspective  
19 about what is doable today and what is -- what will be  
20 a bigger challenge is very helpful. And I think it can  
21 help our staff really focus on addressing each of these  
22 pieces.

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1           Now, NFA is obviously -- Chris, you mentioned  
2 in your remarks that having your members, NFA members,  
3 kind of respond to this. Gerry, you said, let's not  
4 wait for a big bang. What can be done -- how can the  
5 FCM solution move forward and not necessarily waiting  
6 for a comprehensive solution either from DSIO or NFA,  
7 how does this all come together? What is possible?

8           MR. HEHMEYER: If I could, I think Gerry and  
9 I are saying in many ways exactly the same thing. I  
10 couldn't agree with Gerry any more that the places on  
11 that balance sheet, like bank depositories, that is  
12 pretty easy. So collecting the information that Gerry  
13 just presented, and having an electronic system that  
14 can confirm some of the balances of those thousand  
15 accounts around the industry, and maybe it's a couple  
16 hundred of the easy ones, we can get that done pretty  
17 fast.

18           It's the more complicated deposits that -- as  
19 Gerry just went through, that makes it more difficult.  
20 But that shouldn't hold us back. We can phase this in.  
21 It doesn't have to be big, hairy monster all at once.  
22 It can definitely be a phased thing, and we can move

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1 pretty quickly to do that. Don't you agree, Gerry?

2 MR. CORCORAN: I agree. And, you know, I  
3 would say that most fraud takes place in the cash  
4 domain and not necessarily within the trading element  
5 of the relationship with the CCPs. So if we can nail  
6 down cash, you know, we have really closed one element  
7 of the window. But the typical element a fraudster  
8 plays in is in cash.

9 MR. KENNEDY: Gerry, I apologize, because I  
10 was late -- at a dentist appointment, but you said --

11 MR. CORCORAN: "Dentist," right?

12 MR. KENNEDY: Yes.

13 MR. CORCORAN: I thought you may have just  
14 said "tennis".

15 MR. KENNEDY: No, not tennis. Not tennis.

16 (Laughter.)

17 Dentist, and I would much prefer to have been here.

18 You said that cash could be done near term,  
19 and I didn't see the full presentation. Was the main  
20 other accounts those trading accounts with the CCPs?  
21 Or is there a third bucket of accounts?

22 MR. CORCORAN: There is a third bucket of



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1 accounts, and that is customer assets that are invested  
2 in securities that would be held at custodial  
3 locations.

4 MR. KENNEDY: Okay. So you have the cash  
5 accounts, the custodial, and then the CCP.

6 MR. CORCORAN: That's pretty much the three  
7 big buckets.

8 MR. KENNEDY: Three big buckets. You think  
9 the cash side, we could get direct electronic for the  
10 NFA and CME and the other SROs pretty promptly.

11 MR. CORCORAN: Correct.

12 MR. KENNEDY: How long do you think it would  
13 take for the other two buckets?

14 MR. CORCORAN: Well, the custodial balances  
15 won't be difficult either. Those aren't real-time  
16 necessarily. Those are T1. So those are end-of-day  
17 balances that you would get shortly after the close of  
18 business. But, you know, you also have to --

19 MR. KENNEDY: So two areas, the cash deposit  
20 accounts and the custodial caps, I mean, there will be  
21 work -- there will be work, but those are relatively --

22 MR. CORCORAN: Correct.

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1           MR. KENNEDY:  -- straightforward.

2           MR. CORCORAN:  And then, when you have the  
3   DSROs, let's just use RJO as an example when we talk  
4   about the exchanges.  If the CME is -- which is our  
5   DSRO -- is doing the verification of assets for RJO,  
6   they have, of course, the balances for our OTC at the  
7   firm. And they would have access to our balancing  
8   statements next day, roughly around the same time the  
9   seg report is done.

10           The point in that, Chairman, is that there is  
11   usually a reconciliation process involved.  It is not  
12   necessarily a match off, okay, RJO says 20 million, the  
13   CME says 20 million, it's done.  There's differences,  
14   and I think there will probably be, you know, a  
15   statistical way to look at differences and say, "What  
16   has to be investigated and what doesn't?"

17           If we're within 99 percent, or 98 percent of  
18   a match off, maybe it's not investigated on a daily  
19   basis.  If it's, you know, 80 percent or 90 percent,  
20   then, yes, I think there needs to be an element of  
21   human intervention to ascertain what is causing the  
22   difference.

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1           MR. KENNEDY: And as your DSRO, they would  
2 have their balances at that clearinghouse, but they  
3 wouldn't necessarily have the balances at other  
4 clearinghouses.

5           MR. CORCORAN: Correct. Correct. So there  
6 will have to be, you know, cooperation amongst  
7 clearinghouses to provide data to the DSROs on a real-  
8 time or T1 basis.

9           MR. KENNEDY: And then, for those that are  
10 members that are non-clearing FCMs -- non-clearing FCMs  
11 would really just have the cash accounts and the  
12 custodial accounts.

13          MR. HEHMEYER: Maybe. It is -- I agree with  
14 Gerry.

15          MR. CORCORAN: They would have omnibus  
16 accounts with clearing firms.

17          MR. HEHMEYER: They would have omnibus  
18 accounts, and FCMs are good seg locations to each  
19 other. And that's where it probably gets to be  
20 complex, because a smaller FCM may not have all this  
21 capability. But the big pieces -- the banks and  
22 broker-dealers -- that are good seg locations -- and

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1 clearinghouses.

2 Clearinghouses and banks are the easiest.  
3 Broker-dealers are next. Then, other FCMs and then  
4 other depositories that are approved for seg. It gets  
5 to -- and those are the smaller amounts of the total  
6 U.S. seg, but that's where the complexity comes in.  
7 The big pieces are fairly easy. I think we can do that  
8 fairly quickly. And how long to do that is -- we are  
9 going to work at NFA to try to figure that out.

10 MR. KENNEDY: And so as Gary Barnett, his  
11 folks, final -- I mean, they already have in front of  
12 us Commissioners some rule text. But as they tweak it  
13 and finalize it, what I'm hearing is there may need to  
14 be a little bit specificity about cash balances,  
15 custodial balances, and those balances at  
16 clearinghouses, at least those three main buckets, that  
17 there may be a little different language in each, all  
18 with the same goal that the self-regulatory  
19 organizations would have some direct access, or maybe  
20 not. I'm just trying to help Gary out here.

21 MR. HEHMEYER: I think it's the category of  
22 custodian that probably gets complicated. CCPs and the

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1 banks are relatively easy. The custodians, if you  
2 will, which are all good seg locations, come in  
3 different sizes and shapes.

4 COMMISSIONER O'MALIA: Thank you, Gerry.  
5 Mike, go next?

6 MR. DAWLEY: Great. Good morning,  
7 Commissioner O'Malia. Also, good morning, Chairman  
8 Gensler and Commissioner Chilton and the TAC Committee.  
9 My name is Mike Dawley. I look at Goldman  
10 Sachs' futures clearing business, and I am also  
11 Chairman of the Futures Industry Association, also  
12 known as FIA. It predominantly represents the FCM  
13 community, but also has exchanges and clearinghouses  
14 and a host of other market participants from 20-plus  
15 countries as members.

16 First off, I would like to commend  
17 Commissioner O'Malia for leveraging the TAC Committee  
18 to at least initially focus on this very important area  
19 related to customer asset protection. There is  
20 certainly a lot being focused on by regulators in the  
21 industry post MF and now Peregrine, but honing in on  
22 implementing data verification.

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1                   Functionality is a critical step in assuring  
2 what I reference as a foundation of confidence -- in  
3 other words, making sure that regulators and any  
4 information disseminated to the public reflects  
5 reality. As we know, both in the MF Global and  
6 Peregrine events, the information that auditors were  
7 looking at was either completely fictitious or wasn't  
8 providing a clear and complete picture of the firm's  
9 situation.

10                  We must assure we arm our regulators with the  
11 most robust tools as to weed out not only the evolving  
12 fraudsters but also the sloppy and operationally  
13 deficient firms. So transparency is really the key  
14 here, and, you know, to the extent possible I think FCM  
15 -- they just have to be able to provide regulators, and  
16 our customers in some respects, granular information on  
17 the amount of funds they are holding on behalf of  
18 clients and where those funds are located.

19                  As you know, the MF Global bankruptcy started  
20 a lot of processes, one of which was FIA, putting out  
21 some recommendations, and also FIA supporting the CME  
22 and NFA initiatives to require FCMs to report their

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1 segregation calculations required under CFTC rules on a  
2 daily basis, and twice monthly report investment of  
3 customer funds.

4           With the Peregrine failure, that is probably  
5 not enough. So, you know, I think one additional  
6 requirement we fully support is the SRO's decision to  
7 require FCMs to permit electronic confirmation of  
8 client segregated balances, as well as their proposal  
9 to permit regulators real-time view-only access to the  
10 FCM's customer bank and custodial account, so -- which  
11 is really the topic of today.

12           I think we can get into the weeds later as to  
13 how we might attack some of these challenges. I think  
14 we have kicked off well, and Gerry did a great job of  
15 pointing out how many accounts might be involved. I  
16 have no idea how many we have at our FCM, but I would  
17 expect it is something similar. But I do think it will  
18 vary by firm.

19           But we are anxious to work with the CFTC and  
20 the SROs to look at expanding this concept, where  
21 possible, and to assure, as I said before, that  
22 regulators have a clear and complete picture of a

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1 firm's status on as close to a real-time basis as  
2 possible. I think we are going to be challenged by  
3 being able to do too much real time, but I think we  
4 should explore how far we can take this.

5 Separately, FIA is actively considering how  
6 to construct and populate an FCM informational portal,  
7 if you will. In the spirit of transparency, we feel  
8 there could be value in allowing the public and  
9 regulators access to a portal which centrally houses  
10 public information and other material information about  
11 FCMs in order for customers to more thoroughly evaluate  
12 and understand their service provider.

13 Technology is obviously critical in this  
14 effort in assuring that regulators and customers get  
15 the right information. And we also look forward to  
16 working with the CFTC and SROs on that idea at this  
17 stage.

18 But, you know, also, as important as all of  
19 these steps are, we can't lose sight of the fact that,  
20 you know, all of this will be greatly diminished  
21 unless, you know, firms have strong internal controls.  
22 I don't want to lose focus of that. FIA recommended a



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1 whole host of things in February that represent best  
2 practices, and we believe most FCMs are already  
3 following those. Sadly, you know, these internal  
4 control best practices weren't followed by the likes of  
5 Peregrine and MF, but we do think that is a really  
6 important precursor to, you know, implementing an  
7 electronic solution.

8 I would also say, as the Committee and the  
9 CFTC move forward on these issues, I would encourage  
10 you to also take advantage of the FIA's Financial  
11 Management Committee. This committee is comprised of  
12 senior FCM treasury and finance professionals, as well  
13 as representatives of various depositories. They have  
14 been meeting regularly since the MF Global bankruptcy  
15 and were primarily responsible for preparing FIA's  
16 recommendations for customer fund protection, which  
17 were released in February also.

18 The members of this committee have an  
19 exceptional depth of knowledge and are willing to work  
20 with the SROs and the Commission to help implement an  
21 electronic confirmation program or any other  
22 improvements that assure that customer funds are

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1 protected.

2 I'm not going to go on too much longer with  
3 these comments, but, look, I'll be honest, I think the  
4 world is pretty surreal these days. And after 30-plus  
5 years in the futures industry, I never would have  
6 expected that the stars would have lined up like they  
7 have over the last nine months, having witnessed a long  
8 list of major events that in some form affected the  
9 futures industry going back to the Hunt Brothers solar  
10 squeeze or the bearings event or the crash of '87,  
11 several events in the '90s, including the Niederhoffer  
12 losses that converted into the Refco fraud, all the way  
13 up through the Lehman Brothers bankruptcy.

14 You know, I just think none of these seem to  
15 compare to the back-to-back events of MF Global and  
16 Peregrine. The damage they have done is just -- it's  
17 just awful. I think, you know, we really need to feel  
18 for those who lost money directly in these two  
19 situations, but it's important to note that we are all  
20 victims here.

21 The trickle-down effect is devastating, and I  
22 couldn't begin to put a dollar amount on the -- on what

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1 this has cost. I mean, between resource spending and a  
2 loss of business, loss of productivity, I expect it to  
3 be a far greater number than what was misappropriated  
4 by MF and Mr. Wassendorf.

5           So we owe those who were directly violated,  
6 and we owe ourselves to quickly, to Gerry's point,  
7 identify specific deliverables that will restore  
8 confidence and assure compliance with the rules and the  
9 law.

10           With that said, I look forward to today's  
11 discussion. I'm going to be happy to answer questions.  
12 And, you know, quite honestly, I am confident that --  
13 and this has been the case for decades -- that this  
14 industry will direct all of its passion and pride  
15 towards a solution that, you know, will be meaningful  
16 and hopefully enhance and bring back client confidence.

17           So those are my remarks. I think, you know,  
18 a couple of comments based on what I have heard out of  
19 Chris and Gerry, I think -- you know, I agree with  
20 everything Gerry said. I think his presentation was  
21 great. The seg calculation that he put up on the board  
22 is like such an important process for all of us, and to

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1 delve into that and understand it is going to be really  
2 important for regulators.

3           I don't know how many auditors would really  
4 have appreciated that there is all of these different  
5 locations on that one piece of paper that really need  
6 to be delved into. So I think -- I really think it is  
7 important for the regulators to be fully informed and  
8 educated on this process before we enter into any sort  
9 of a technology build, because there are complications.  
10 We have to determine, okay, what do we want to report,  
11 in what form, when do we want to do it, what time of  
12 day, and there is a whole host of other things that I  
13 think we would need to standardize across custodians  
14 and clearinghouses and FCMs and banks.

15           So I will stop there, Commissioner.

16           COMMISSIONER O'MALIA: Thank you very much.  
17 You know, I suspect beginning with MF and heightened by  
18 Peregrine, that your customers are calling and they are  
19 saying, "Where is my money? Why can't" -- or what --  
20 rather than me guessing at what they're saying, what  
21 are they asking you to do? What changes are -- you  
22 know, I assume we are roughly on the same page, but are

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1 they asking for anything different than what we are  
2 considering today?

3 MR. DAWLEY: It has been an interesting  
4 several years, I'll say this, and it really goes back  
5 to Lehman. The events of Lehman's bankruptcy forced a  
6 whole wave of questions, and it involved an educational  
7 process with clients to understand how bankruptcy works  
8 and how the law is different in the UK versus the U.S.

9 You know, MF was a whole other problem, which  
10 involved internal controls. And when you went -- when  
11 clients asked whether something like that could happen  
12 at our firm, it really involved having to educate  
13 clients about what goes on internally at your firm.  
14 How are the seg calcs done? Who does them? Are there  
15 proper separations of duties? What is the oversight?  
16 Who audits those sorts of things?

17 And then, you have Peregrine enter the scene,  
18 which is outright theft, and, you know, that is a  
19 different conversation. So Lehman, MF, Peregrine, all  
20 terrible, challenging events, but all very different  
21 also. And, you know, the calls do keep coming in. We  
22 are continually -- and this is to my point where I say

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1 that the cost to the industry and the trickle-down  
2 effect is enormous.

3           You know, the FCMs are spending the majority  
4 of their time dealing with this issue. I spend 70  
5 percent of my time on dealing with these issues as an  
6 FCM head, and it is -- you know, it is very unfortunate  
7 that these two organizations have caused this. But I  
8 do think that there is a lot of really good  
9 enhancements we can make.

10           We are already heading down that path, and I  
11 think, Scott, your ideas here and what you are focused  
12 on is really the core of all of it. It is really that  
13 verification process that makes everything else kind of  
14 work better. So I couldn't be more supportive of  
15 implementing something like this. And I think, you  
16 know, that's what we really should work together on.

17           We need to get into the details. We need to  
18 sequence it properly. I agree, I think we start with  
19 the banks -- that's kind of low hanging fruit in my  
20 view -- and get those done, and then move on to  
21 custodians, and then figure out how we are going to  
22 handle the global environment, which really gets

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1 challenging.

2           Just to give you an example what my seg calc  
3 might look like, I have one line item on there that  
4 says GS International, our UK affiliate, which is, in  
5 essence, the window into the rest of the world.

6           COMMISSIONER O'MALIA: All right. Well, that  
7 was my next question. When I asked Gary Barnett, what  
8 is his plan for the Part 30 funds, you know, these are  
9 still U.S. customers seeking exposure overseas. Money  
10 starts with an FCM in the U.S. It is placed overseas.  
11 How do we protect them, and what is the technology  
12 solution there?

13           MR. DAWLEY: Yes. I mean, look, this is  
14 where you are going to have affiliates verifying  
15 balances, right? But we all know that those balances  
16 end up being passed through to Singapore and Korea and  
17 Tokyo and Spain and Germany. So, you know, that's to  
18 my earlier point also. How far do we want to take this  
19 initially?

20           I think this should be an evolving effort. I  
21 actually agree that the more transparency we provide  
22 the better. It is just a question of, how are we going

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1 to do it efficiently and assure that the data is  
2 actually meaningful and useful, not only to regulators  
3 but also to clients? And, you know, we are committed  
4 at FIA to work with the Commission and the SROs on  
5 this, but I'm not going to deny the fact that it's a  
6 big lift to really make this work on a global basis.

7 MR. KENNEDY: Mike, I thought your words were  
8 very poignant. I mean, these various events, and maybe  
9 going back to Lehman, as you say, highlight how  
10 important it is to rebuild some confidence, a system  
11 that has worked well for decades gets challenged as --  
12 challenged by new fraudsters in the case of Wassendorf,  
13 or new operational failures. And, as you said, some of  
14 these have different varieties.

15 So I am encouraged. I think we have done a  
16 lot working with the market. I mean, these various  
17 initiatives of the NFA just finalized, and we worked  
18 with you all and the NFA on -- I think are strong, but  
19 my first question is going to be, what are clients  
20 saying? Of these initiatives that we just put in place,  
21 closing what I will call the "hole" in the Part 30  
22 account that all FCMs now have to do net liquidation



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1 rather than alternative, saying that excess -- to tip  
2 your hand into the excess house money that is in the  
3 seg account, you have to have senior management sign  
4 off if it's more than 25 percent, and the daily  
5 reporting and the other key reporting information.

6 What are you hearing from people on this package that  
7 is it enough, but it is a significant package we all  
8 put together in the last six months?

9 MR. DAWLEY: I think, you know, that's a  
10 great question, and I think -- I think the enhancements  
11 are really, really meaningful. Now, do clients  
12 appreciate them yet? Probably not. They're rattled,  
13 and they should be. It is really up to us as FCMs, and  
14 the regulators, to educate -- continue to educate  
15 clients as to how this process is going to work and why  
16 these enhancements are so meaningful.

17 It was quite interesting, you know, to really  
18 learn, especially post Lehman, how little the buy side  
19 really knew about how FCMs operate on a daily basis.  
20 So, you know, it has been -- and I welcome this. Our  
21 firm is very supportive of clients being as educated as  
22 possible, and I think it is just going to take more of

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1   that, Gary.

2                   I think we just have to make sure that we  
3   make our clients aware of how the system works, where  
4   their risks lie. Are we going to be able to mitigate  
5   every single risk? Probably not. But as long as  
6   clients are comfortable and appreciate where the risk  
7   might lie, we are better off.

8                   MR. KENNEDY: So, I mean, we are looking to  
9   take that package that we worked together on at the NFA  
10  and put that in, you know, our federal rulebook as  
11  well.

12                  MR. DAWLEY: Yep.

13                  MR. KENNEDY: So to the extent -- I mean, we  
14  are hopefully going to do that in the very near term,  
15  put it out to public comment, even though it is already  
16  in the NFA rulebook.

17                  MR. DAWLEY: The sooner the better as far as  
18  I'm concerned. We support the NFA 16 fully, and I  
19  think it is important to get that thing implemented.

20                  MR. KENNEDY: At the federal level as well.

21                  MR. DAWLEY: Sure. Yeah, yeah. I think the  
22  NFA goes when, Chris, September 1st or --

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1                   MR. HEHMEYER: I'm not sure, but I think  
2 something like that.

3                   MR. KENNEDY: Yeah, I think that's right. I  
4 mean, it will be -- just for the media, it will be  
5 implemented when NFA does it. But we want to put it in  
6 our rulebook as well.

7                   MR. DAWLEY: Yeah.

8                   MR. KENNEDY: The second piece of it, which  
9 is this direct access to custodial bank accounts and  
10 this -- and the clearing accounts, I'm hearing some,  
11 you know, growing consensus. There is a lot of details  
12 to work out, but growing consensus. We're going to try  
13 to put that out to public comment as well, but it might  
14 be that NFA is going to be doing something even at  
15 their August Board meeting, as I understand, which is  
16 encouraging.

17                   But I had a question in that regard, just on  
18 the details. You talked about all of the international  
19 accounts. Was that in this seg account or in the  
20 secured? So is it, you know, Part 30 or is it -- I'm  
21 just trying to --

22                   MR. DAWLEY: Both accounts involve client

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1 assets, so, you know, how you actually structure  
2 inability to --

3 MR. KENNEDY: No. My question was following  
4 -- or in the segregated account, do you also have the  
5 affiliates in Korea and Singapore and London involved  
6 in that, or is that -- was that a reference just to the  
7 Part  
8 30?

9 MR. DAWLEY: This is to Part 30.

10 MR. KENNEDY: All right. So Part 30.

11 MR. DAWLEY: My point was really that in  
12 order for FCMS to operate efficiently, there is a  
13 structure of utilizing affiliates as good seg  
14 locations, in addition to just using other FCMS for  
15 good seg locations, which came out of Gerry's --

16 MR. KENNEDY: But if we were either phasing  
17 or being nuanced to say that the direct electronic  
18 asset for the seg accounts might precede some of what  
19 goes on internationally in the Part 30, is that what  
20 you are trying to highlight? Or are you saying, is  
21 that an international component?

22 MR. DAWLEY: I think I understand -- I mean,

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1 as far as sequencing, I think we start with the seg  
2 balances. I think I view that as lower hanging fruit  
3 that we can get sorted much quicker than grappling with  
4 some of the complexities that are going to involve the  
5 global --

6 MR. KENNEDY: On the international.

7 MR. DAWLEY: Yeah, exactly.

8 COMMISSIONER O'MALIA: Gerry, do you want to  
9 comment on where any Part 30 money was in that balance  
10 sheet you showed?

11 MR. CORCORAN: There wasn't any in that  
12 balance sheet. That was just the seg report. I chose  
13 not to do the secured Part 30, just because of time.

14 MR. KENNEDY: And I'm just going to use this  
15 opportunity. Beyond those two buckets that -- putting  
16 in our rulebook what we work with NFA on, and this  
17 direct access piece, the other two pieces -- or at  
18 least two other pieces is transparency, that investors  
19 have more transparency -- and I think, Mike, you were  
20 talking about that through your portal, but we are also  
21 considering whether we should incorporate in some rules  
22 some greater investor transparency.

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1           And then, the other piece is the internal  
2 controls piece, which we have all been talking about,  
3 but separations of duties, and so forth.

4           When we look back to our rulebooks from -- a  
5 lot of this goes back to the 1970s and '80s, and so  
6 forth. There -- frankly, there are very limited words  
7 that we -- the intent might have been there for  
8 separation of duty, and the intent might have been  
9 there for good auditing standards. But we think that  
10 it's appropriate to put more words on the page about  
11 these internal controls.

12           MR. DAWLEY: I would agree with you, Mr.  
13 Chairman. I think that is a big part of what needs to  
14 be -- everybody needs to be comfortable with the  
15 internal controls that exist out there, and that there  
16 is checks and balances around them. So I think the  
17 best practices that we have put out can be expanded on,  
18 and we will continue to work with you and the SROs to  
19 assure that those are fine-tuned. And, you know, I  
20 just think that's important.

21           And as far as the informational kind of  
22 portal idea, we have been working with Gary Barnett and

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1 bouncing ideas off of him. I think -- you know, I  
2 don't think we are necessarily -- we necessarily care  
3 who does something. It's just like we see value in it,  
4 so FIA, for example, could create this portal, it could  
5 be a regulator that -- or an SRO that creates it. I  
6 think the same holds true for this verification process  
7 where we are seeing that NFA is doing this.

8 But, you know, should there be a central, you  
9 know, newly created entity that kind of houses this  
10 function? I don't know where it needs to belong. It  
11 feels like a regulatory oversight, you know, exercise.  
12 So, but I do think we should think about where it  
13 should sit and who should build it and maintain -- you  
14 know, especially as we look to automate it and make it  
15 a much more efficient process versus the initial days  
16 where we will probably still be using passwords to log  
17 in and identify balances.

18 That is just not going to work long term. We  
19 need to figure out how to get data files sent to some  
20 sort of a system that needs -- I think still needs to  
21 be built. And maybe that is -- one of the panelists  
22 here today, one of the vendor solutions could

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1 potentially provide that sort of a service.

2           COMMISSIONER O'MALIA: Well, that is  
3 certainly something we need to move to and discuss  
4 that. And I will -- as much as we have talked about  
5 new rules and proposals and ideas to impose on the  
6 industry, we need to be reflecting on our capacity in  
7 the Commission of our technological capacity to  
8 integrate all of this stuff.

9           And we need to make it a priority and talk  
10 about it in very specific terms and lay out a plan as  
11 to how we are going to tackle this, so, you know, we  
12 can be -- have the appropriate regulatory response to  
13 all of this as well.

14           We are going to go to Bryan Durkin. Yes,  
15 Commissioner Chilton.

16           COMMISSIONER CHILTON: Yes. The Chairman  
17 asked a couple of questions that were a little bit off  
18 technology, so I am going to go there just this one  
19 time. I promise I won't do it again. And thanks, Mike,  
20 for your leadership. I know it has been a tough time  
21 for the industry as well, and I do commend, you know,  
22 the Financial Management Committee, who came up with



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1 these recommendations very early on, and a lot of them  
2 were really good.

3 But I do want to press you on two different  
4 things. One, in June, I had called for full  
5 segregation, full-on segregation where customers could  
6 choose whether or not their money went directly to some  
7 trust, either a clearinghouse or some other entity.  
8 You know, the FCMs would be allowed to charge more if a  
9 customer chose to not have their money be used for  
10 anything other than their trades and their margins.  
11 But I'm curious about your thoughts on that, and then I  
12 have one other question after you answer that one.

13 MR. DAWLEY: Sure, Commissioner Chilton.  
14 Look, I agree with you. I think that what has come out  
15 of some of these events has been this concern and this  
16 demand for some sort of a segregation regime that  
17 involves individual -- seg as it is referred to. And I  
18 think at FIA, and as an FCM and as Goldman Sachs, we  
19 have been very supportive in wanting to get into the  
20 detail around how such a system may work.

21 And I think, as you know, Commissioner, there  
22 has been a group that has been put together --

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1 segregation working group -- that hasn't met in a bit,  
2 but I am about to reunite the band here again shortly,  
3 but that has talked about all of these different  
4 models, including full seg and LSOC. And I think it is  
5 still a work in progress, and I think people are still  
6 exploring ways to provide choice to customers and  
7 trying to evaluate what the cost may be.

8               We might get there. It is complex. There  
9 are a lot of bankruptcy-related issues that are  
10 involved and funding challenges. But we are still  
11 working on it.

12              COMMISSIONER CHILTON: Well, now, they do  
13 allow full seg in the EU, if I'm not mistaken. And how  
14 do you guys deal with it over there?

15              MR. DAWLEY: Yeah. It's a little different.  
16 It does involve funding. But I think as far as how the  
17 liens work, and that sort of thing, it's different than  
18 how U.S. bankruptcy law works today. So we have had a  
19 lot of discussions with Bob Wasserman, and we have had  
20 a lot of very intelligent bankruptcy attorneys and a  
21 whole host of other folks delving into the weeds on  
22 this to try and figure out a solution that can work in

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1 the U.S. So we will keep you posted on that.

2 COMMISSIONER CHILTON: Thank you. I mean, it  
3 -- in general, you know, when we do something, I think  
4 it's good for the EU to look at it for their benefit,  
5 good or bad or ugly. I think the same thing with  
6 regard to the EU's -- we just looked at what might be  
7 lurking over there.

8 And again, Scott, I won't go off technology  
9 topic after this, but there's this issue of an  
10 insurance fund, Mike. And, you know, I mentioned it in  
11 my opening comments, that, you know, the reaction I  
12 have received so far is it's expensive.

13 But, you know, the conversation can't just  
14 end there. I just understand it would cost money, but  
15 I also understand that they do this in a bunch of  
16 countries, some in the EU and South Africa and  
17 Australia. Somebody told me it was Brazil -- I think  
18 it's Brazil, maybe Argentina. So it's not like, you  
19 know, there can't be -- you know, smart people can't  
20 figure out a way around this.

21 It just seems unfair to me that security  
22 customers are protected, that banking customers are

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1 protected, and futures customers aren't. So if it's so  
2 expensive, maybe there's a premium, or maybe they're  
3 not protected to the extent that the FDIC or CPIC cover  
4 people. But to just say it's expensive and leave the  
5 issue seems negligent to me.

6           So I guess, for one, I'm interested in your  
7 comments; and, two, whether or not your Financial  
8 Management Committee is -- maybe this is something they  
9 can look at.

10           MR. DAWLEY: Sure. First of all, I don't  
11 know who said it is too expensive. I hope you are not  
12 saying it was me.

13           Look, I don't know if it's too expensive or  
14 not. What I -- my view on insurance is that, you know,  
15 it hasn't been analyzed enough. And one thing I will  
16 just share with you, one thing I brought up at I think  
17 it might have been an FIA Board meeting or exec comm  
18 was maybe we should look into insurance. Maybe we  
19 should have somebody like the IFM, which is a not-for-  
20 profit who has got funding pay for a study and hire the  
21 right people to kind of piece together some ideas  
22 around an insurance fund that might work.

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1           I don't know if it will work or not. I just  
2 don't have enough information. But I do agree with you  
3 that I think it makes sense to study it. And if  
4 qualified people come back and say, "Here is what it  
5 costs, and it looks expensive," at least we will know  
6 that it is truly expensive. I think the other  
7 complications that come out of an insurance fund is who  
8 pays for it and who does it cover. You know, I just  
9 think we have to be careful there so we're not lowering  
10 the bar and providing coverage for, you know,  
11 organizations that might not be up to snuff, knowing  
12 that they have this backstop.

13           So I am supportive of looking into it. I  
14 just don't know whether or not it is feasible and it  
15 can work in an efficient and effective way yet. But I  
16 will move forward with trying to get an analysis done.

17           COMMISSIONER CHILTON: Thank you. And thanks  
18 for your patience on non-technology stuff. And thanks  
19 for your leadership, Mike.

20           I will be quite for a while, Scott.

21           Thank you.

22           COMMISSIONER O'MALIA: Thank you,

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1 Commissioner Chilton.

2 Bryan Durkin.

3 MR. DURKIN: Thank you, Commissioner O'Malia,  
4 and distinguished panelists on a topic that has  
5 impacted this industry beyond belief since the MF  
6 Global and PFG situations. We have all collectively --  
7 the SROs, the CFTC, the NFA, the FCM community,  
8 particularly our work with the FIA and the NFA and the  
9 working groups attendant to these initiatives -- have  
10 all been deeply focused on one goal, and that goal is  
11 restoring the confidence in all aspects of our  
12 industry, of our customers, by ensuring that from these  
13 deeply appalling events that our industry and the  
14 confidence in our industry brings itself back to a  
15 level of confidence that we have all collectively  
16 worked for -- some of us for decades to achieve. We  
17 need our customers to have that confidence restored.

18 Now, through these two recent incidents,  
19 although it appears that the firms may be at fault,  
20 this is a problem that we all have to work towards  
21 resolution as an industry. We have to regain that  
22 trust, and every link of the chain must be as strong as

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1 the next.

2           And so, Commissioner O'Malia, we commend you  
3 for initiating this day today to make this more of a  
4 technology focus, because I'm hoping to be able to show  
5 to you that, even through these very unfortunate  
6 events, we are a very resilient industry. We can rise  
7 above challenges, and we have taken initiatives, and we  
8 have made strides in these last several months towards  
9 that end.

10           We have learned a few lessons from, you know,  
11 what we felt was an impenetrable operation in terms of  
12 what we have collectively put together as an industry.  
13 We have added some enhancements to our overall  
14 reporting requirements, our rules and regulations, and  
15 everything that we have done to this date is really  
16 designed to enhance customer protection and to  
17 reinstill and reconfirm that confidence in these  
18 tremendous markets that we represent.

19           What I am attempting to focus on today in how  
20 we have been utilizing the tools, the policies, and the  
21 rules that we have put in place, is to further augment  
22 what we view to be very strong self-regulatory

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1 processes and programs that have been in place and have  
2 been the compilation of the ingenuity and the integrity  
3 of many around this room, of the Joint Audit Committee,  
4 in the efforts of the leadership of these fine  
5 organizations.

6           At the hub of all of this is enhancing the  
7 strength of the programs that we have in place from our  
8 auditing and our risk management capabilities as SROs,  
9 augmenting it through the introduction of technology-  
10 based solutions that enhance the information that is at  
11 our disposal, to be able to identify on a more timely  
12 basis any issues that may raise some concern or alerts  
13 us to concerns that we can go into the field and take  
14 immediate action based upon that information.

15           We have made some great progress with respect  
16 to the confirmation of information that can be provided  
17 to the SROs. And although I missed Chris' presentation  
18 -- and I apologize for that -- I'm sure that he has  
19 alluded to, and has represented, what we together as  
20 SROs are working towards to provide near real-time  
21 confirmations in the context of, what is maintained at  
22 the firm's depositories?



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1           But to take a little step in terms of what we  
2 are doing with the information that we have at our  
3 disposal, we are, in the context of our yearly risk-  
4 based examinations that our audit team performs,  
5 through the incorporation of the additional data that  
6 we have received, in the context of the requirements  
7 for electronic confirmations, as well as the daily  
8 reporting of segregated information from all of our  
9 firms, that information is incorporated in the context  
10 of our field work that we conduct as part of our audit  
11 testing. That information is utilized, as we speak, in  
12 the context of further reconciliation and validation of  
13 the information that has been provided and reported to  
14 us by the firms.

15           The information is very valuable to us in the  
16 context of our daily monitoring, and the systems that  
17 we have in place for conducting that daily monitoring.

18           Separate and apart from the more detailed  
19 annual risk-based examinations that our audit team  
20 performs, we are also incorporating that information in  
21 the context of our limited scope reviews and our spot  
22 checks that we have undertaken. We have instituted an

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1 increase in the number of spot checks -- and you may  
2 recall this -- since December of last year.

3           And as we incorporate the information that is  
4 being reported to us, both in the context of segregated  
5 information that comes our way daily, as well as the  
6 investment of segregated assets, all of those items are  
7 very important to us in the context of serving for  
8 further validation and tie-in of the information that  
9 we receive and that has been reported to us from the  
10 clearing firms.

11           The electronic confirmation aspect is going  
12 to be very key to us in the context of third party  
13 validation of the information that is reported by the  
14 third parties, and primarily confirming the bank  
15 balances through the third party depository.

16           Having access to this system provides us even  
17 greater confidence in the context of the security  
18 information, obtaining that information --

19           MR. KENNEDY: Bryan, can I just ask you one  
20 question? When did the CME group start to use this --  
21 you call it Capital Confirmation, Inc., but the  
22 electronic confirmations?

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1 MR. DURKIN: Relatively recently. Ann Fagan?

2 MS. FAGAN: This month.

3 MR. DURKIN: Yeah, just in the last four --  
4 three or four weeks.

5 MR. KENNEDY: So since these events have  
6 transpired.

7 MR. DURKIN: Yes.

8 MR. KENNEDY: Okay.

9 MR. DURKIN: And in incorporating this  
10 information, we, you know, feel very strongly about  
11 making this a requirement in the context of performing  
12 our field audits.

13 There is a third part of this in the context  
14 of working with other DCOs and ensuring that we are  
15 able to provide similar confirmations from the other  
16 DCOs that have mutual common clearing member firms, and  
17 we were working towards ensuring a process and a  
18 mechanism in place, so that we are able to cover those  
19 relationships.

20 Effective May 1st of 2012, we required all  
21 FCM clearing members to submit customer segregated  
22 daily statements electronically to the CME, and we have

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1 incorporated those reports in the context of our  
2 internal surveillance and our monitoring. How we go  
3 about doing that is in the context of reviews that we  
4 have developed through our automated monitoring of  
5 financial statements and financial reporting from the  
6 firms.

7           We have incorporated certain alerts and  
8 tolerance levels in the context of now further  
9 incorporating this information as a further validation  
10 and reconciliation of what we have, you know, on record  
11 in comparison to month-end segregation reports and  
12 doing a corresponding reconciliation with what is being  
13 submitted to us daily.

14           We are also very much supportive -- and I  
15 know that that has been spoken to earlier by a number  
16 of our panelists and colleagues here today -- of  
17 requiring the FCMs to provide direct real-only online  
18 access to the depository information. Again, having  
19 access to that information, to state the obvious,  
20 provides additional validation and confirmation of the  
21 accuracy of the segregated information that is being  
22 reported to us by our firms.

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1           Effective July 16th, we initiated a limited  
2 review in the context of the requirements that were put  
3 in place for the reporting of investment reports. So  
4 semimonthly -- our firms are required to submit to us  
5 semimonthly reports, investments, reflecting the  
6 customer segregated funds, where those funds are  
7 invested, the dates that those funds were invested, who  
8 are the depositories of those funds, and the  
9 instruments that those funds have been invested in.

10           And receiving that information twice monthly,  
11 again, that is incorporated in our risk-based reviews,  
12 and it provides us with more real-time information in  
13 the context of validating what has been reported to us  
14 by the firms. And it certainly is an added tool for us  
15 in the context of our full scope audits.

16           CME is currently using the Confirmation.com  
17 to perform its reviews of the FCM clearing members,  
18 particularly in the context of our review of customer  
19 segregation statements. We are incorporating this  
20 information in the context of conducting surprise  
21 audits of our firms, and what we are looking for is any  
22 material differences in the context of our risk-based

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1 examinations of all of our firms that we are  
2 responsible for.

3           We will certainly incorporate this  
4 information as more requirements evolve out of the work  
5 that has been done with the SRO Committee, as well as  
6 our interactions in coordination with the FIA and the  
7 CFTC. We are fully prepared to further augment the  
8 data and the reporting of this information into the  
9 context of reinforcing our very strong self-regulatory  
10 programs.

11           COMMISSIONER O'MALIA: Thank you very much.  
12 We are going to go with Alun, Chris, and then Steve.

13           MR. GREEN: Thank you very much,  
14 Commissioner. I don't know if we can get the  
15 presentation going.

16           (Pause.)

17 Thank you, and thank you to the committee for giving me  
18 the opportunity to come -- thank you to the committee  
19 and the Commissioner and the Chairman for giving us the  
20 opportunity to come and talk about how we may be able  
21 to see what is possible from a technology perspective  
22 when we address this area.

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1           I just want to spend a moment to talk about  
2 SunGard. We are a technology financial services firm.  
3 We are a global firm, and we provide services in the  
4 post-trade area, suddenly and listed derivatives, but  
5 also in securities, banking, and reconciliation. So a  
6 number of the areas that we are looking at are things  
7 that we have got experience with.

8           I think when we look at what has been said so  
9 far on customer protection, I think particularly with  
10 the comments from Gerry Corcoran were very instructive  
11 as to how this is happening. I think a lot of the  
12 emphasis that has been put on so far has been around  
13 making a lot of this activity more visible and more  
14 auditable. And I think that that is a very good thing,  
15 to be able to have verification. But there is a manual  
16 element involved in doing that.

17           And I think to the point that Chris was  
18 making, there are maybe two steps to that. I think  
19 there is, firstly, the ability to go in and view what  
20 is going on, but that can be a fairly manual process.  
21 What we really I think need to move towards is what you  
22 would call the big system that gives us the ability to

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1 independently verify what is going on in this customer  
2 protection situation.

3           So when I am looking at things, I am looking  
4 at what would be required to build that big system, and  
5 what are the technology components that are in place  
6 there.

7           So I see four elements to customer  
8 protection. The first one, again, as really brought out  
9 by Gerry, is to verify the actual client liability. So  
10 the FCM has got a view as to what the funds are that  
11 have been deposited with them. The funds need to be  
12 moved into the segregated asset accounts.

13           Then, there is the client liability, as we  
14 said, from the DCO side. They are holding the  
15 positions. They know what the margin requirements are.  
16 And, finally, the depositories who are holding those  
17 segregated assets.

18           So we've got the liability, as it is viewed  
19 from the FCM, who has got the client position, and by  
20 the DCO, who has got the FCM position. And then, we've  
21 got the assets, again, from the FCM, who has got the  
22 client funds, and from the depository, who has got the



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1 FCM funds. And in order to independently replicate and  
2 verify the segregation calculation, we need to look at  
3 these four elements.

4 I think one point to make is that a lot of  
5 this work is being done today. A lot of it is being  
6 automated on a daily basis. Again, going back to  
7 Chris' point, very little is done real time today.  
8 Most of it is done in a batch system. But most of  
9 these different reconciliations are being done within  
10 firms, within financial institutions. There is just no  
11 visibility to that process for either the SRO or for  
12 the regulator. And that is what I am going to focus on.

13 So in the current situation, you've got the  
14 reconciliation between the FCM and the DCO. This is --  
15 can be very complex. Gerry mentioned the idea of all  
16 of the out trades that could be coming in. We are  
17 looking here not just at reconciliation of cash, but  
18 reconciliation of trading positions, which obviously  
19 tie into that very closely.

20 This is being done, however, by every firm  
21 with every DCO on a daily basis when we are talking  
22 about the U.S., but obviously similar situations are

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1 occurring globally. So the foreign merchants, the  
2 foreign brokers, are reconciling with our local  
3 clearinghouses and exchanges as well.

4           The second piece is the reconciliation of the  
5 assets. In preparing the seg reports, the FCM are  
6 going to be looking at their bank statements. There is  
7 probably less happening electronically here today than  
8 people would like. Again, that will vary considerably  
9 from firm to firm, and depending upon the capabilities  
10 of the different depositories as well.

11           Those funds are being checked. The FCM, in  
12 preparing that statement, is looking at what they have  
13 on deposit and is able to do that reconciliation.

14           They then are using those two pieces -- the  
15 liability piece that has been reconciled with positions  
16 at the clearing organization, and the asset piece that  
17 has been reconciled with the banks, custody banks, and  
18 with the DCOs, and from that they put together the  
19 elements of the segregation calculation that Gerry  
20 showed very well in his presentation.

21           One piece that is not happening is any kind  
22 of independent reconciliation between, you know, what

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1 the liability is as it states through the DCO, and what  
2 the assets are as they are happening, you know, sitting  
3 in the depository. Everything at the moment is  
4 happening within the FCM.

5           So I think the proposed customer protection  
6 model is to have that done centrally, whether it's by  
7 the CFTC themselves, by the NFA, or the other SROs, or  
8 by some other body. And those four elements need to be  
9 provided in order to fully independently verify that  
10 the funds are properly protected.

11           Then, what you are going to have is a  
12 centrally reconciled view of the liability, of the  
13 asset, and a clear indication on each FCM as to the  
14 amount of cushion that they've got in their  
15 segregation, the ability to put up alerts and  
16 thresholds depending upon what it is that is felt  
17 necessary.

18           All of those technology components exist  
19 today. These reconciliations are all happening on a  
20 daily basis. Some of them are happening on a real-time  
21 basis. All of them are happening at least on an end-  
22 of-day batch basis. What is not being done is they are

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1 not being done consistently using consistent formats.  
2 Some firms will be doing part of it manually. Some  
3 firms may have automated all of it, but there are  
4 different ways of getting the data from the different  
5 DCOs even, certainly different ways of getting data  
6 from the different depositories and from the foreign  
7 firms.

8               So the complexity comes with trying to bring  
9 together things are happening that are happening in a  
10 different light, and that is something where I think  
11 the industry could help by setting standards. A lot of  
12 standards have already been set by FIX and by FpML and  
13 other institutions like that.

14              So putting together some kind of standard,  
15 and a requirement to confirm, would give us the ability  
16 to put all of this data into a central location and  
17 build the big system that Chris was talking about.

18              I don't believe that that big system is as  
19 huge as people are expecting. You know, a lot of those  
20 components already exist, and it is simply a case of  
21 repurposing them to act as a central system rather than  
22 to act as an individual system for each bank.

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1           The only additional notes -- a lot of this  
2 applies equally to the segregated and to the foreign  
3 secured protection. The complexity with the foreign  
4 secured comes with just the variety and number of  
5 different institutions that would have to provide this  
6 information, and, as well, the point that Mike made,  
7 that in many cases these were affiliates who were  
8 providing on behalf of the -- you know, their  
9 counterparty in the U.S.

10           and how far down the chain do you want to go  
11 with that relationship.

12           Most of these report details, to reiterate,  
13 they are already in place. Some of them are being  
14 introduced as part of gross customer margin. And it is  
15 not a big change, I believe, for the industry to have  
16 these provided to a central location.

17           Thank you.

18           COMMISSIONER O'MALIA: Some of the challenges  
19 on this 30.7, though, are how do you make that work? I  
20 mean, people pointed out, I mean, just by jurisdiction  
21 you are going to have challenges.

22           MR. GREEN: You are certainly going to have

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1 jurisdictional challenges, and particularly as you go  
2 down the chain it is very hard for somebody in the U.S.  
3 to be able to enforce that without at least  
4 some kind of cooperation. I don't know how many depths  
5 of relationship people have got. Mike was saying that  
6 his UK entity is the view into the rest of the world.  
7 I don't know if the UK then goes to Singapore, which  
8 then goes to Hong Kong, which then goes to Korea. You  
9 know, tracing that all the way back is difficult from a  
10 legal perspective, not from a system perspective -- all  
11 of the data and the information is there -- but I'm not  
12 sure how you would be able to get that going all the  
13 way through from the jurisdictional.

14 COMMISSIONER O'MALIA: All right. We did not  
15 have your presentation beforehand, so it's not in the  
16 packets, and nor is it on the website yet, which is the  
17 venue in which we are trying to provide all of the  
18 material. Both Alun and Gerry, do you have any  
19 objection to us putting your presentation on the  
20 website? You put some numbers in there --

21 MR. CORCORAN: We put some sensitive company  
22 data in there that -- let me talk to our General

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1 Counsel first.

2 COMMISSIONER O'MALIA: Fair enough.

3 MR. CORCORAN: Thank you.

4 MR. GREEN: Yeah. I have no objection.

5 MR. KENNEDY: But, Gerry, it is sort of  
6 already in the public domain, I would note, you know,  
7 because probably somebody was Twitter feeding it or  
8 something up there.

9 (Laughter.)

10 MR. CORCORAN: I'm just covering my butt.

11 (Laughter.)

12 COMMISSIONER O'MALIA: Maybe you can check  
13 that box at lunch.

14 MR. CORCORAN: It's public information, so  
15 let me just check. But I am certain it will be okay.

16 COMMISSIONER O'MALIA: Okay. But you --  
17 Alun, you had no objection?

18 MR. GREEN: No objection.

19 COMMISSIONER O'MALIA: All right. We will  
20 circulate it, and we will try to have his presentation  
21 put in your decks on your table by the end of -- by  
22 lunchtime.

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1 Chris?

2 MR. DURKIN: Chris, I suspect what has been  
3 bad for the futures industry has been all right for  
4 your business.

5 MR. SCHELLHORN: Well, it has been very busy.  
6 That is for sure. We certainly haven't been at a loss  
7 for things to do the last week or so. And my colleague  
8 who has been on a speaking tour is the brain -- he has  
9 been the brain trust, so it has been interesting. But  
10 thank you, Chairman Gensler, and Commissioner, for  
11 inviting us to speak.

12 What I would like to do is talk a little bit  
13 about the role that Confirmation.com played in  
14 uncovering the PFG Best fraud, and how Confirmation.com  
15 can be used going forward to continue to protect  
16 investor funds and uncover or deter fraud.

17 As background, Confirmation.com is the  
18 creator and patent holder for secure online audit  
19 confirmations. My colleague and the founder of  
20 Confirmation.com, Brian Fox, a CPA who worked for both  
21 Ernst & Young and PricewaterhouseCoopers in the early  
22 '90s, recognized that not only was the paper and fax



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1 process for audit confirmations inefficient, delivering  
2 confirmations back to the auditors four to six weeks  
3 after a request was made, he also recognized that the  
4 paper process could be easily manipulated by fraudsters  
5 looking to steal or misuse the cash from the businesses  
6 they ran and the cash provided by their investors.

7           Twelve years ago, Confirmation.com created  
8 the first secure online clearinghouse for audit  
9 confirmations, which now allows auditors to receive  
10 confirmation requests back in under 60 seconds and has  
11 been effective in uncovering multiple confirmation  
12 frauds -- namely, the PFG Best fraud, as well as  
13 others, including a U.S. listed company fraud and many  
14 of the Chinese company listed reverse mergers frauds.

15           Each year, Confirmation.com processes more  
16 than \$1 trillion in confirmation data, processing  
17 millions of confirmations for more than 10,000  
18 regulatory bodies, external audit firms, and internal  
19 audit departments. With access to thousands of banks  
20 through our network, 70 of the top 100 banks respond to  
21 confirmations through Confirmation.com, to include 19  
22 of the top 20 U.S. banks, as well as the U.S. Federal

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1 Reserve Bank, which launched our service last year.

2 Twenty-five banks, including such names as

3 Bank of America, HSBC, Citizens Bank, BB&T, SunTrust,

4 have mandated the use of Confirmation.com and won't

5 respond to confirmations sent to them any other way.

6 Every top 100 accounting firm in the country sends

7 confirmation requests through our service, and we are

8 endorsed by the American Bankers Association as well as

9 being a preferred provider of electronic confirmations

10 for the American Institute of CPAs.

11 In fact, one note -- 18 of the companies

12 represented by attendees here today are users of our

13 services, either requesters, responders, or clients.

14 Confirmation fraud, by way of background, dates back

15 100 years to McKesson & Robbins' fraud which was first

16 recorded -- which was the first recorded confirmation

17 fraud.

18 Within the last 10 years alone, we have seen

19 more than 40 public company frauds involving mailed and

20 faxed audit confirmations. Included are the 14-year

21 Olympus fraud which cost investors more than \$4-1/2

22 billion in market cap value and involved individuals at

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1 three different banks who intentionally responded  
2 falsely to audit confirmations.

3 Parmalat, which fabricated a \$4.9 billion  
4 bank account and concealed it for 10 years and cost  
5 investors 97 percent of their shareholder value in less  
6 than a week, along with many others such as Refco,  
7 Ahold, Kmart, and the majority of reverse Chinese  
8 merger frauds, like Sino-Forest and China-Biotics.

9 Our solution caught the PFG Best fraud, and  
10 if used, even on a monthly basis, could have resulted  
11 in uncovering the MF Global situation.

12 Ideally, though, the mandatory use of our  
13 service would significantly --

14 MR. KENNEDY: Chris, can I just ask, is that  
15 Refco the Refco that we sometimes talk about in the  
16 futures world?

17 MR. SCHELLHORN: Yes.

18 MR. KENNEDY: So it had confirmation fraud.

19 MR. SCHELLHORN: Yes.

20 MR. KENNEDY: Not around segregated accounts  
21 but around bond confirms with the auditors. Is that  
22 what that said?

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1 MR. SCHELLHORN: That's correct.

2 MR. KENNEDY: Okay. Thank you.

3 MR. SCHELLHORN: Confirmation fraud happens  
4 one of two ways -- the fraudster gets someone at a bank  
5 to intentionally respond to the auditors with false  
6 confirmation information, which happened at Olympus  
7 where individuals at three different banks  
8 intentionally provided false and misleading information  
9 to auditors, or the fraudster controls the location  
10 where the confirmations are sent, making it look like  
11 the bank responded, which is what happened with both  
12 the PFG Best and Parmalat confirmation frauds.

13 Most auditors today don't utilize the full  
14 capability of our service, because most auditors still  
15 send confirmations just once a year.  
16 Confirmation.com's full capabilities have been used to  
17 provide confirmation responses in less than 60 seconds,  
18 and we have users who provide confirmation responses as  
19 frequently as five times per day through electronic  
20 interfaces.

21 We have long been advocates for sending  
22 confirmations more than just one more time per year,

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1 because doing so can be significant -- can be a  
2 significant deterrent to fraud, and at the very least  
3 reduce the timeframe that fraud could occur, thereby  
4 potentially limiting investor losses.

5           Our service is a cloud-based solution, where  
6 both the requester and responder can self-register,  
7 begin to use the service almost immediately, with no  
8 hardware or software to install or maintain. Because  
9 most banks don't prioritize audit confirmation  
10 responses until perhaps today, we provide three levels  
11 of solution to banks. The first level has the ability  
12 to push or request data from banks we have not  
13 registered -- who have not registered with our service.

14           The second level -- registered banks -- to  
15 literally begin using the service today, the day they  
16 register, until they are able to allocate the IR  
17 resources necessary to tie into the Confirmation.com  
18 platform.

19           And the third level, which is a secure FTP  
20 for automated confirmation responses. This third level  
21 integrates with banks' legacy systems, allows the banks  
22 to electronically provide confirmation response data

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1 through Confirmation.com to auditors. And we have  
2 documented a data communication standard for  
3 confirmations based on the work that we have done with  
4 some of our partners.

5           While many people in the room would assume  
6 that each person working for a public accounting firm,  
7 internal audit department, or outside regulator, has  
8 honest intentions because of their fiduciary role to  
9 the public. What probably isn't a surprise to others  
10 is that with hundreds of thousands of individuals  
11 having used our service over the last 12 years, we have  
12 had attempts where those with fiduciary role tried to  
13 take advantage of the technology to gain unauthorized  
14 access to private financial data.

15           One can only guess at their motives --  
16 curiosity, accident, knowledge for personal responses.  
17 But access to private financial information must come  
18 with certain controls to mitigate unauthorized access.  
19 With these controls, most banks' legal counsels won't  
20 allow for the release of private financial information.  
21 This is primarily because, absent such approval, the  
22 bank would have no way to determine that the auditor is

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1 making a request on an entity which is actually under  
2 the auditor's purview where the auditor has the proper  
3 authorization to provide that private financial data.

4           Without a mechanism for verifiable  
5 authorization from the bank's client to the bank, it  
6 would be easy for someone to gain unauthorized access  
7 to private data. To alleviate this concern for the  
8 banks, Confirmation.com's system provides a patented  
9 mechanism for proper authorization by the client to the  
10 banks for the release of the information based on the  
11 bank's internal legal requirements. This has allowed  
12 us to be successful in blocking unauthorized  
13 individuals from gaining access to private financial  
14 information.

15           Based on the unique needs of the auditors,  
16 Confirmation.com's service can be configured to the two  
17 extremes, where in one case the client approval must be  
18 given on every request, or on the other extreme where a  
19 single initial approval is provided, allowing the  
20 auditor to send confirmations any time, as often as the  
21 auditor would like, which is the option that we see is  
22 needed with the solution being discussed here today.

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1           While a balance in isolation won't identify  
2 fraud or the misuse of funds, Confirmation.com's system  
3 can be enabled to automatically match confirmation  
4 response data to third party data to ensure accuracy.  
5 This capability, in conjunction with parameters that  
6 can be set to trigger flags for auditors which identify  
7 anomalies occurring outside, learn standard deviations,  
8 could indicate possible fraud or unusual account  
9 activity.

10           We certainly understand and recognize what is  
11 really needed is to restore investor confidence.  
12 Confirmation.com has been working on the solution you  
13 seek, we think for the last decade. With millions of  
14 confirmations to identify, multiple frauds is proof of  
15 the success we've had.

16           And the ultimate solution that the market  
17 desires is the one we have envisioned, the core of  
18 which is we believe built today and in use today. The  
19 solution we would propose is a cloud service that  
20 allows for transparency into the cash balances for both  
21 the auditors and investors as often as both parties  
22 require and is useful to them, that being near



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1 instantaneous, whether hourly, daily, monthly,  
2 quarterly, or annually.

3           It allows for quick and simple use of an  
4 integration by all parties which will identify  
5 anomalies through both predetermined parameters and  
6 learned standard deviations and provides usable reports  
7 for analysis by auditors and investors.

8           With access to thousands of banks using our  
9 Level 1 solution, and hundreds of banks, including 70  
10 of the top 100 banks, the Federal Reserve, are already  
11 using Confirmation.com's Level 2 service, and Level 3  
12 solutions, along with more than 60,000 auditors,  
13 hundreds of thousands of audit companies, and with a  
14 solution that is also utilized by and beneficial to  
15 even the smallest of our community bank users,  
16 Confirmation.com's clearinghouse is an effective, cost  
17 efficient service through which banks provide clarity  
18 and transparency into the cash positions of the  
19 companies being audited.

20           I would like to thank the Committee again,  
21 Commissioner, for allowing us to speak at this panel  
22 today. We spent the past 12 years focused on catching

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1 fraudsters and eliminating confirmation fraud through  
2 the use of an efficient, cloud-based technology. We  
3 have a proven system in place today, and we are  
4 prepared to work with whatever group to modify that to  
5 meet the needs of the CFTC.

6 COMMISSIONER O'MALIA: Based on what our  
7 Director of DSIO said, Gary Barnett, he said this  
8 24/7/365 view only. Can you provide that?

9 MR. SCHELLHORN: We could. I think the  
10 biggest need is the financial institutions that  
11 participate to feed that data to us on a regular basis.

12 COMMISSIONER O'MALIA: Okay. I'm sorry for  
13 not knowing this answer, but what is the difference  
14 between what you are doing and something like Swift?

15 MR. SCHELLHORN: My understanding of Swift,  
16 it is much more granular from a transactional  
17 perspective as opposed to immediate access to balances.

18 COMMISSIONER O'MALIA: The transaction  
19 itself. Confirming the transaction, yes.

20 MR. SCHELLHORN: And we have had some  
21 conversations with Swift on how we could work together,  
22 but that was my understanding was theirs is

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1 predominantly transactional-based.

2 COMMISSIONER O'MALIA: Okay. That leaves  
3 Steve Hurst batting cleanup.

4 MR. HURST: Good morning, everybody. My name  
5 is Steve Hurst. I am from the Merchants Data  
6 Repository. I can chat for a moment while it is being  
7 set up.

8 Thank you for the opportunity to be here  
9 today. Before I go much further, I would like to  
10 introduce my colleague, Kevin Walsh, who is sitting in  
11 the back here. Kevin has a great deal -- years of  
12 experience of running a trading and dealing desk in the  
13 custody environment using technology that is well  
14 settled in the banking sector. Much of that technology  
15 is relevant to what I am here to talk about today.

16 And when we break for lunch, and throughout  
17 the afternoon, I hope you will take an opportunity to  
18 meet Kevin and engage with him. He has much to offer  
19 to the conversation about an independent third party  
20 utility.

21 Thank you.

22 Merchants Data Repository is a new,

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1 independently operated, third party utility.

2 MR. KENNEDY: Can I just ask, Steve, just  
3 because I had to step out for a second -- can I just  
4 ask Chris a question about the market confirmation? If  
5 you take 2011, or whatever recent data you have, what  
6 portion of the accounting profession -- auditing -- I'm  
7 sorry, auditing profession uses electronic  
8 confirmations as opposed to the paper? You know, 10  
9 years ago, it was all paper, fax, et cetera. And I  
10 don't have a sense of --

11 MR. SCHELLHORN: We would tell you --

12 MR. KENNEDY: -- where we are. And I should  
13 ask it, like if they do a thousand audits a year, you  
14 know, however you would measure it --

15 MR. SCHELLHORN: I understand the question.

16 MR. KENNEDY: -- or do a thousand confirms a  
17 year, what does the market now look like, electronic  
18 versus paper?

19 MR. SCHELLHORN: Our estimate is that we are  
20 still in the very early stages, still pretty well on  
21 the curve. It is probably no more than 15 percent.

22 MR. KENNEDY: So, you know, well over 85

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1 percent is still in the paper/fax world.

2 MR. SCHELLHORN: Correct.

3 MR. KENNEDY: And it was --

4 MR. SCHELLHORN: Moving quickly to  
5 electronic, but still -- it is still a long way to go.

6 MR. KENNEDY: Okay.

7 MR. SCHELLHORN: Even the firms that -- all  
8 the firms that I cited -- the 10,000 firms, the Big 4  
9 that use their service, they don't use it universally  
10 for many reasons. But we are getting there slowly.

11 MR. KENNEDY: And would it have been two  
12 years ago sort of like, you know, it was 98 or 99  
13 percent was still paper and --

14 MR. SCHELLHORN: Correct. It has really been  
15 in the last four years that we have seen a dramatic  
16 increase in our --

17 MR. KENNEDY: From zero to, you know --

18 MR. SCHELLHORN: And what has really driven  
19 that are the financial institutions that have come to  
20 us and said, "We don't want the paper anymore. We  
21 don't want to deal with the potential risk that exists  
22 in paper. We are going to mandate the service. We are

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1 going to require that this is the channel that  
2 confirmations come to us."

3 MR. KENNEDY: And maybe it's a question for  
4 Chris, or I see Dan Roth here, too. What led -- when  
5 did NFA get to, you know, this and --

6 MR. HEYMEYER: I'll let that Chris answer  
7 that question. That's a good question.

8 MR. KENNEDY: All right

9 MR. SCHELLHORN: We began dialogue with NFA  
10 about a year ago when they started to introduce the  
11 service I want to say back at the beginning of this  
12 year.

13 MR. HEHMEYER: Which was after MF. And so I  
14 think, by a funny exchange that I heard later, John  
15 Tamgard had a friend that knew Chris who sent Chris to  
16 Dan Roth who sent him to Regina, and then Regina said  
17 we ought to try this.

18 MR. SCHELLHORN: That's exactly right.

19 MR. KENNEDY: I knew John Tamgard would be in  
20 here somewhere.

21 (Laughter.)

22 MR. SCHELLHORN: He gets the credit for it

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1 somehow, right?

2 COMMISSIONER O'MALIA: Can I ask one  
3 question? I think you said there are a couple of levels  
4 of authority. Does your system allow for banks to just  
5 push out this data on -- could it allow for that to be  
6 pushed out?

7 MR. SCHELLHORN: It could. We are not -- we  
8 are there in a sense. We have a bank that does that  
9 today. We would be prepared to do that for as many or  
10 as few as would be willing to participate. The  
11 challenge usually is the financial institutions'  
12 technology resources and their availability to support  
13 their own projects. So we are -- but we could  
14 certainly accommodate that.

15 MR. HEHMEYER: I was just going to comment  
16 that gets into a little bit of the complexity of  
17 requiring this econ form stuff by rule, because a  
18 couple of the banks -- and they are complying quickly  
19 -- are having to get their documents in order to be  
20 able to comply with this that are seg depositories. It  
21 is happening quickly, but it is slow. It is just -- it  
22 is slower than you would think.

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1           MR. KENNEDY: But if we were you and we were  
2 to do it by rule, then you could have a phased  
3 compliance.

4           MR. HEHMEYER: Right.

5           MR. KENNEDY: You could give some -- I mean,  
6 there is ways to address it to get it in the rulebooks  
7 and then phase it as well, right?

8           MR. HEHMEYER: Correct.

9           COMMISSIONER O'MALIA: Steve, I'm sorry.  
10 Back to you.

11           MR. HURST: No problem. By way of  
12 introduction, Merchants Data Repository was originally  
13 created as a trade reporting repository. We think the  
14 trade reporting repositories are one of the more  
15 important ideas promulgated under Dodd-Frank. If they  
16 had been in existence a few years ago at the time of  
17 the crisis, some of the problems, like with AIG, might  
18 have been averted. We think there are lessons that were  
19 learned there that can be applied here.

20           Over the last 18 months or so, Kevin and I  
21 have been out in the marketplace talking to a wide  
22 variety of market participants. We have met with



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1 international commercial and investment banking  
2 companies, market regulators, prudential regulators,  
3 trust and custody banks, who have an important role to  
4 play here we think, investment management firms,  
5 insurance companies, pension plans, sponsors and  
6 managers, and producers, merchandisers, commercials,  
7 and non-commercial end users in the agricultural  
8 sector.

9           And one thing became apparent to us very  
10 quickly, that with all of the data, the transactional  
11 data that is being gathered by all of the repositories  
12 that are being set up for all of the different asset  
13 classes all over the globe, how can you possibly use  
14 that data effectively if you do not also have access to  
15 the collateral that is underlying those transactions?

16           It is not possible to assess risk on  
17 transactional data without having access to the  
18 collateral. And one of the important points that we  
19 think should be considered here is how while addressing  
20 these problems you might get a "two for."

21           CPSS/IOSCO identified gaps in collateral  
22 reporting 18 months ago. The Commission held hearings

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1 and took testimony about the value of creating a  
2 central repository to collect collateral data that can  
3 be used for risk assessment, both by the firms and by  
4 regulators. There is an opportunity now, while we  
5 address the problems that brought us here today, to  
6 address that problem as well. And I think it is  
7 important to keep that in mind.

8           We also worried early on that collateral  
9 considerations could have an impact on the clearing  
10 mandate. There are institutional investors that have  
11 become comfortable with having their funds held in  
12 individually segregated accounts under tri-party  
13 custody agreements at global trust and custody banks  
14 that are governed by ISDA/CSAs.

15           And in order for them to participate in the  
16 clearing opportunity that they are urgently interested  
17 in doing, they have to change their collateral  
18 protection mechanism from having an individually  
19 segregated account to having it moved into the system  
20 that we are all familiar here with futures.

21           That has been problematic for some time.  
22 And, regrettably, as events have played out, the

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1 concerns they have have been manifested in ways that  
2 none of us ever imagined. MF Global exposed gaps in  
3 structures that everybody in this room believed were  
4 inviolate until quite recently, and Peregrine has  
5 exposed a dark side of our industry. And this double  
6 whammy has caused fair- minded people to question  
7 whether or not we should be entitled to self-  
8 regulation, and, more importantly, whether -- questions  
9 are being raised about the fundamental structure of our  
10 market. And the people that are raising these  
11 questions are our customers.

12           And a year ago, the customers that were  
13 concerned about this were in Stanford and Greenwich and  
14 Mayfair and Canary Wharf in London, and today they are  
15 in Omaha and Minneapolis and St. Louis. And they are  
16 not investment fund managers; they are producers, they  
17 are merchandisers, they are commercials, they are  
18 commercial end users. And they know that there are  
19 collateral protection mechanisms that are available in  
20 the market, systems that are embedded in the banking  
21 system that are available to other investors in the  
22 derivatives markets that are not available to them.

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1           And I am here today to tell you that there  
2 are ways in which we could make those systems available  
3 to that community immediately. One of the things that  
4 I would like to address as we go through the afternoon  
5 is whether or not there are ways in which, as Gary  
6 said, not waiting, getting started, if there are ways  
7 where we could proceed in parallel to test individual  
8 collateral segregation programs while the reporting  
9 systems that have been discussed by Chris and by my  
10 colleague at the end of the table from me confirm it  
11 has an impressive system, what Mike is talking about  
12 with the portal, all of those things could and should  
13 go on as soon as possible.

14           And I'm suggesting that in parallel with that  
15 a pilot program should be initiated that would enable  
16 individual collateral segregation mechanisms to be  
17 tested as well. To put it very simply, there is a  
18 structural problem here that is perceived by our  
19 customers, and a structural solution is needed.

20           So we are here today to give you some ideas  
21 about -- and a concept for how individually segregated  
22 accounts could be brought to market quickly. They are

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1 a fact of life at most swap dealers. It's the way that  
2 market works. These systems that exist today are  
3 clumsy. They are proprietary. They are operationally  
4 complex. They can be expensive, and the reason for that  
5 is they are not shared by anyone. Each dealer has its  
6 own system for managing these accounts.

7           We think great things could happen if the  
8 dealers got together and, instead of competing with  
9 each other to have the best technology, deployed one  
10 central platform in one central location, shared the  
11 cost, and made the services available to their  
12 customers as the customers perceive it. We don't think  
13 this is something that should be mandated. We think it  
14 should be optional from the customer's perspective.

15           I would also tell you that the technology  
16 alone is not going to be enough. There will need to be  
17 other things to address the loss of trust that has  
18 occurred in the industry, and we think having a central  
19 venue to house this platform would have several  
20 advantages. We have central venues for trade execution  
21 today. We have central venues for clearing. We will  
22 soon have central venues for post-trade reporting. Why

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1 not a central venue for protection of customer funds?

2           We think those -- the attributes listed would  
3 serve us well. They would encourage transparency, best  
4 practices, standardized systems, and lower costs. And  
5 we think having a neutral intermediary, providing a  
6 central venue, would facilitate those needs.

7           We also think that there is a way to use a  
8 central venue if organized by the industry and  
9 supported by the industry to test the insurance  
10 markets. When you start getting into the details of  
11 the insurance issue, the central question is, what is  
12 the risk profile that is exposed to the market. In the  
13 same way that every FCM looks at a customer and tries  
14 to assess risk, the insurance markets are going to look  
15 at it the same way.

16           They will look at the risk presented by a  
17 central counterparty for clearing differently than they  
18 would a collection of FCMs coming together to provide  
19 an insurance solution that is built upon a technology  
20 solution. And I would encourage you to think about  
21 insurance in this capacity.

22           So we have all talked about the landscape

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1 today. I am not going to dwell on that, other than to  
2 say that the tri-party custody environment in the swap  
3 market uses technology that is well embedded, broadly  
4 distributed, and has been tested in a real-time  
5 environment and that technology is available today.

6           We are proposing to deploy that technology,  
7 working cooperatively with the trust and custody banks,  
8 using the same systems they use to facilitate the tri-  
9 party custody model, in a single purpose entity  
10 operated by a neutral third party, organized by this  
11 industry.

12           We think that FCMs have the relationships  
13 with the customers. It should be FCMs that provide  
14 this service to their customers, and we think the  
15 customers ought to have a choice as to whether or not  
16 they do business in the traditional model or whether  
17 they use a new third party service to enable them to  
18 hold their funds in an individually segregated bank  
19 account.

20           The service will be able to maintain a secure  
21 database of portfolios that is sortable, reportable,  
22 and available to customers and regulators addressing

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1 some of the issues that Alun discussed in terms of  
2 standardizing process and keeping the parameters  
3 consistent.

4           We have addressed the data gaps that were  
5 referenced by the CPSS/IOSCO report more than a year  
6 ago. You'd give the customers that want the ability to  
7 hold their money in a bank account the ability to do  
8 so, and there would be a transparent view of the funds  
9 on deposit at this facility that would be available to  
10 customers, to FCMs, and to regulators.

11           The key features of our proposal are that  
12 this is a service bureau for the FCM community. It is  
13 the FCMs that will make this service available to their  
14 customers as they see fit. We are proposing a utility  
15 model. This entity would undertake no other  
16 activities. It wouldn't undertake any risk. It would  
17 exist for one purpose and one purpose only, and that is  
18 to manage the accounts of the customers for the FCMs.

19           The accounts would be held at custodian banks  
20 that are settlement banks of the DCOs. This would be a  
21 regulated entity with a rulebook, subject to CFTC  
22 oversight. The rulebook would supplant the control



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1 agreements that are common with custodians in the over-  
2 the-counter market. The custodians would exercise  
3 absolutely no discretion in managing the account. They  
4 would be bound by the rulebook, and the rulebook would  
5 be well understood and available to customers.

6           The FCM business model would be preserved.  
7 The FCMs would remain as the clearing member. They  
8 would remain the primary face for the customer. They  
9 would retain control over the margin requirements and  
10 position limits that are set when they bring in a new  
11 customer account. They would simply outsource the  
12 managing of the custodial accounts and the development  
13 of the technology to a new, independent entity. It  
14 would be a shared outsourced solution that would  
15 leverage existing custody infrastructure.

16           This is a simplified version of the way  
17 business has been conducted in our industry for years.  
18 We have two customers that are conducting futures  
19 transactions through an FCM, the funds held in a  
20 collateral pool, an omnibus account that is segregated,  
21 and cleared at a clearing organization.

22           The model we are proposing is shown here.

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1 Backing up, there are your two customers using the  
2 traditional model; those same two customers are at the  
3 top of this slide. They are conducting their business  
4 the way they always have. But customer three shown  
5 here has opened an account in the customer's name, held  
6 by the repository, at a trust and custody bank that is  
7 also a depository of the clearing organization that is  
8 going to undertake to clear the trade.

9           The clearing organization would hold a  
10 separate account at the same financial institution. As  
11 margin is called for to support the trade by the DCO,  
12 one account - - the DCO account -- calls for money from  
13 the customer account inside the repository which is  
14 facilitated by a book entry transfer in exactly the  
15 same way that margin moves in the over-the-counter  
16 markets today.

17           This is nothing new. This technology is  
18 available. It can be deployed easily. I shouldn't say  
19 easily. It can be deployed without having to invent  
20 anything new. It is a matter of implementing the will  
21 and getting the job done.

22           In an even more simplified process, again, we

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1 have the repository at the bottom of this slide. Here  
2 it is in the center. You have the client of the FCM  
3 that is permissioned by the FCM to use this new  
4 facility to hold its funds. The FCM provides the  
5 customer with access. The customer opens the account at  
6 the repository. As the DCO calls for margin, the  
7 repository allocates funds to the DCO's account. As  
8 the DCO pays margin, the flows work in reverse. All  
9 accounts will be held at leading trust and custody  
10 banks that are also DCO repositories. And the  
11 relationships and responsibilities between customers,  
12 custodians, the FCMs, and DCOs will be defined in a  
13 rulebook approved by the Commission.

14           For end users, having an independent neutral  
15 third party holding the account will be helpful in  
16 addressing the bankruptcy issues. Structural  
17 protection will be provided, which will address the  
18 concerns that many customers are raising today. The  
19 funds would be held on deposit at leading trust and  
20 custody banks, and the rulebook would define rights and  
21 responsibilities.

22           The funds on deposit would be completely

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1 transparent, both to customers via established banking  
2 platforms and easily verifiable by FCMs and regulators.  
3 For the FCMs, the benefits here are restoring trust and  
4 confidence in the market. We have a structural  
5 problem. This addresses that problem with a structural  
6 solution.

7           The FCMs would maintain the customer  
8 relationships, continue to enjoy their access to  
9 clearing, be able to provide a full segregation option  
10 for customers that are willing to pay for it, and  
11 enhance their existing business models. We think there  
12 are cost efficiencies here that could be realized by a  
13 cooperative effort amongst like-minded firms that  
14 leverage existing custody platforms, and the result  
15 would be restored trust and confidence in our markets.

16           In conclusion, I would simply say that my  
17 roots in this industry come out of the agricultural  
18 industry. I started out years ago trying to create new  
19 competition in this industry by launching a new central  
20 venue for trade execution. We took the old Merchants  
21 Exchange -- some of you will remember -- had it  
22 designated as a contract market, and had a go.

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1           It didn't work out well for us, but we  
2   learned a lot. But our roots are in the agricultural  
3   sector. The people that I have my best contacts with,  
4   and my organization has its best contacts with, are in  
5   the agricultural sector. Those people don't understand  
6   how this happened. They view it as structural problem,  
7   and they want to see a structural solution implemented  
8   now.

9           I have been working on this for 18 months.  
10   We - - Chairman Gensler, you and I have never met. For  
11   us to get started doing what we want to do, it is not  
12   that complicated. We need a safe harbor in which  
13   customers -- and they are out there right now --  
14   customers can test the model that I am proposing, where  
15   they could open up an account, working with their FCM  
16   and with participating clearinghouses, and with brokers  
17   that are also -- we have a handful of brokers that  
18   would like to test this as well, where they could  
19   actually put a trade through and not have to worry  
20   about being assessed an excess margin for putting  
21   something through that might be considered to be  
22   unmarginal under the rules, where the brokers don't

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1 have to worry about being hit with some sort of  
2 penalty, where the customers know that the CFTC is  
3 involved in this.

4           And you will see in the testimony that was  
5 delivered yesterday to Congress, the National Grain and  
6 Feed Association is calling for a pilot program. I  
7 would urge you to consider letting us implement that  
8 pilot program today, and let us proceed in parallel  
9 with the other excellent programs that are obviously  
10 moving forward right now.

11           That's what I am here to ask for today, and I  
12 would be happy to answer any questions over lunch or  
13 through the rest of the afternoon.

14           COMMISSIONER O'MALIA: Thank you. I asked  
15 Steve to come because he does have obviously a  
16 different model. This is not a substitute for any of  
17 the technology solutions that we have been focused on  
18 on the previous speakers, but it does warrant some  
19 consideration in reevaluating our futures -- our  
20 intermediary model.

21           I have a couple of questions, though. Is  
22 this utility contemplated in the CEA? I mean, we

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1   require money to be held, customer money to be held in  
2   certain accounts.  Would we need to change the rules to  
3   accommodate this?

4               MR. HURST:  Yes.

5               COMMISSIONER O'MALIA:  Okay.

6               MR. HURST:  And I might add, just to be  
7   complete, data repositories were envisioned, but not  
8   data repositories for collecting collateral data.  I  
9   think that's a relatively small change.

10              There is nowhere in the CEA contemplated  
11   anything close to an entity that would actually hold  
12   and manage customer funds, and I think this entity  
13   would probably need to be duly regulated as a bank, in  
14   cooperation with SEC.  So there is a banking function  
15   here, and there is a repository function here.  And I  
16   think we are going to need to proceed carefully, but I  
17   don't think we have the time to wait for all of the  
18   rules to be implemented, which is why I am proposing  
19   the pilot program and a safe harbor environment, so  
20   that the rules could be addressed while we test the  
21   model.

22              COMMISSIONER O'MALIA:  Let me just, the long

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1 pole in the tent on this one is bankruptcy protection.

2 MR. HURST: Correct.

3 COMMISSIONER O'MALIA: Does this protect you  
4 from a fellow customer failure? And what about pro  
5 rata distribution?

6 MR. HURST: As Mike said, there are a host of  
7 really smart bankruptcy lawyers that are looking at  
8 this and other models. My basic point, to answer your  
9 question, is that having a neutral, independent third  
10 party holding the funds I think will be very beneficial  
11 in that analysis. And I would also point out that  
12 767(h) of the Bankruptcy Code, and the Part 190 rules,  
13 were tightly drafted to take into account the types of  
14 entities that existed at that time. There were no  
15 repositories, and there was never a facility like this.  
16 So I don't think the Code would apply, and I think  
17 there is a lot of advantage here in addressing that  
18 problem and having a neutral third party entity.

19 COMMISSIONER O'MALIA: Well, let me just --  
20 my only concern with bankruptcy is you don't want to  
21 throw customers into an untested, uncharted solution --

22 MR. HURST: Correct.



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1           COMMISSIONER O'MALIA:  -- that courts tie up  
2 for months and months.  We don't ask -- ask any of the  
3 customers in Europe about -- in Lehman or in MF -- how  
4 they are faring.  And to have uncertainty in bankruptcy  
5 is probably the worst fate known to man in terms of  
6 getting your money back.

7           So not that we shouldn't consider this model,  
8 but I just want to make sure we solve for the tough  
9 questions.

10          MR. HURST:  I understand, and I am -- what I  
11 am suggesting to you is the way to do that most  
12 efficiently is for customers that are willing to take  
13 the risk that you are addressing there in a pilot  
14 program environment for a short period of time with a  
15 limited amount of capital at risk.  That is going to be  
16 the best way to give the bankruptcy lawyers what they  
17 need to provide that level of certainty.

18          COMMISSIONER O'MALIA:  And you brought up the  
19 National Grain and Feed Association.  And I -- they  
20 testified yesterday in the House Ag Committee.  They  
21 have also sent us a letter that I will have -- that I  
22 ask be put in the record.  And as has the National

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1 Introducing Brokers Association, who also have a  
2 letter, we will include that in today's kind of meeting  
3 record as well that I will give to the Reporter.

4 MR. HURST: And those are the letters that  
5 describe the segregation regime that they would prefer  
6 --

7 COMMISSIONER O'MALIA: Yes.

8 MR. HURST: -- and the pilot program?

9 COMMISSIONER O'MALIA: Yes. This doesn't  
10 have their full testimony from yesterday, but it talks  
11 about focusing on a technology -- kind of addressing  
12 the narrow -- they had a whole range of --

13 MR. HURST: Right.

14 COMMISSIONER O'MALIA: -- solutions that they  
15 were looking for in terms of customer protection. But  
16 in terms of technology, they are very supportive of  
17 developing a technological verification solution.

18 Believe it or not, we have actually completed  
19 all of the presentations on time, which means we are  
20 going to break for lunch. But I think I would -- Cliff  
21 has been sitting over here and has some thoughts. To  
22 kick things off, just to whet our appetite for this

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1 afternoon's discussion, I thought I would look to Cliff  
2 to raise some questions that we ought to contemplate.

3 MR. LEWIS: And I realize it is because I am  
4 so soft spoken and modest in my views. But I guess,  
5 you know, the first thing I would just say -- and  
6 others on the Committee obviously can speak to this --  
7 you know, we actually, as a custodian, we have talked a  
8 lot about custodians -- and, obviously, our customers  
9 are facing the challenge of being forced into the  
10 clearing regime, just as the clearing regime has been  
11 proven to be broken.

12 So if you are asking about feedback from the  
13 institutions that manage American savings and  
14 retirements, they are petrified. And I would say  
15 fairly so, because the simple point and the test that I  
16 would ask -- and, you know, we have all been in the  
17 industry together, most of us have known each other for  
18 30 years - - is would in fact the various debacles have  
19 been solved or prevented through the mechanisms which  
20 we are discussing today so far?

21 And the answer, on the whole, is no. We're  
22 talking Refco, talking Lehman, talking MF, talking

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1 Peregrine. Now, is there a panacea for all of the  
2 problems? I mean, the answer is obviously not, and  
3 there are some things -- you know, the answer to your  
4 question on obviously we think tri-party custody should  
5 be allowed in the U.S. The reason -- what Steve was  
6 talking about is because the CFTC prevents it by rule.  
7 Elsewhere in the world it is allowed.

8 Does it solve the bankruptcy problem? It  
9 mitigates it. It doesn't solve it. It would prevent  
10 the fraud problem. But so, I'm not suggesting anything  
11 is a panacea, but I think what we need to think about  
12 is sort of in the context of this requirement and the  
13 timeline you guys voted, so it's out, we've got -- you  
14 know, the train has left the station, my clients, on a  
15 rolling schedule, end of next year -- end of next year  
16 -- are going to be clearing a huge amount of product.

17 They have fiduciary responsibilities,  
18 including criminal penalties, to their investors in  
19 terms of how to deal with this system. And, I mean, I  
20 feel for the FCMs, not -- but that is the issue we  
21 should be dealing with. And the fact that they are  
22 right it seems to me to be the fundamental question.

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1           So let's -- I would just suggest that as we  
2 address this, we actually think about the various real  
3 problems that we have encountered -- and I enumerated  
4 the four biggest examples. We have a problem of fraud.  
5 We obviously have a problem -- sorry to be indiscreet,  
6 Chris, but we obviously have a competence problem. And  
7 I know as a banker I now, as one of the senior guys at  
8 State Street -- I sign an agreement which allows --  
9 which makes me criminally and financially liable if we  
10 screw up. There is a claw back, the famous claw back  
11 stuff.

12           Well, you know, one of the questions I've got  
13 is, hey, what are the consequences for some of the  
14 things we have seen where people clearly were not doing  
15 what they were supposed to do? So fraud is one issue.

16           Then, I think there is the issue of  
17 bankruptcy. And, you know, if you are asking that  
18 America's savings be forced, not voluntary as it has  
19 been with futures up until now, but now forced into  
20 this structure, I think you need to have an answer to  
21 the people who hold America's savings, as to how in the  
22 world you are going to protect them in the event of a

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1 bankruptcy.

2           I think the third thing that you need to look  
3 at, obviously -- and this is a general issue about this  
4 - - is operational efficiency. You know, one of my  
5 smartest and biggest clients is sitting to my right,  
6 and, you know, I can defer to Supurna about the  
7 operational complexity of this. The Commission has  
8 taken this to the -- into account in terms of the  
9 phasing.

10           But, you know, again, this is not a simple  
11 thing. The costs are not modest, and, indeed, in some  
12 cases, you know, the costs may outweigh the benefits  
13 for some of the products that are used today, but, fair  
14 enough, if it's transparent.

15           I also think there is another hidden point in  
16 all of this, too, which is pretty straightforward,  
17 which is, you know, the process of market change  
18 obviously hinges on incentives. And, you know, the  
19 reason why some structures -- for example, tri-party  
20 custody -- are used is because of the perception.  
21 There was a successful lobbying campaign at the CFTC  
22 that said this would limit the profitability of FCMs.

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1           CFTC, in its wisdom, well before any of you  
2 there said, "Okay. That's more important than giving  
3 customers the choice of avoiding the kind of Peregrine  
4 problem." And I think that all of those sorts of  
5 issues need to be on the table. I think Dodd-Frank,  
6 you know, lays some of these principles out very  
7 clearly.

8           But it is the level of detail that is really  
9 going to be required to make some of these things work.  
10 And, unfortunately, I don't think there are any simple  
11 answers. But let's look at the -- at least look at the  
12 fraud question, let's look at the bankruptcy question,  
13 let's look at the operational efficiency question, and  
14 I think we also have to look at the conflict of  
15 interest questions, honestly, both on the part of the  
16 regulators and the self-regulatory bodies, and,  
17 frankly, in terms of the industry, because I think you  
18 have seen that there is an inherent conflict.

19           And I would argue this is probably the  
20 biggest thing that would scare me is the conflict  
21 inherent with institutions that are both major market-  
22 maker participants and customer clearing. And it is

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1 that risk of operating both their prop accounts and  
2 their customer accounts.

3           And I think if you look at the Lehman  
4 problem, and if you look at the MF problem, that was  
5 really at the heart of it. I suspect that will be part  
6 of what was going on at Peregrine, too, in the end. It  
7 is very easy to step over the line, given the current  
8 model which allows you to bundle these two activities.  
9 And I would also, by way of -- you know, to be finally  
10 provocative, I think the initial steps on swap clearing  
11 aid and abet a bigger danger from those conflicts than  
12 existed previously.

13           So, in fact, in terms of the detailed  
14 implementation to date, we are worse off now than we  
15 were pre-crisis.

16           Sorry if I was too mild mannered, Scott.

17           COMMISSIONER O'MALIA: No. Thank you. We  
18 are going to let that just sit on the floor for a  
19 while. We are all going to go to lunch, and we are  
20 going to have this discussion.

21           For the TAC members and the panelists, we  
22 would like to continue this discussion downstairs.



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1 Take the escalator down. You will be directed into  
2 where lunch is being provided. And then, we will be  
3 back here at 1:30 to have -- to complete Cliff's  
4 thought and to have everybody else give their thoughts  
5 on technology solutions, broader solutions, and how we  
6 fix this thing.

7               So I appreciate everybody's participation  
8 today. Thank you to the panelists that were able to  
9 deliver on time a lot of good ideas. So thank you very  
10 much.

11               (Whereupon, at 12:38 p.m., the proceedings  
12               recessed for lunch.)

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

14               COMMISSIONER O'MALIA: Let's get started. We  
15 have lost some.

16               The rest of this -- you guys will get a kick  
17 out of this. I just did a CNBC Live, and they had a  
18 technical difficulty and that got dropped halfway  
19 through it, so -- (Laughter.) -- clearly technology is  
20 not perfect. And I got my first Santelli rant, so I  
21 got -- Santelli interjected. He is solving using  
22 technology. Why we hadn't done it earlier.

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1           And obviously there is no -- you know, that  
2 was -- we've got a guy with a technology solution  
3 today. You know, what is fascinating -- and I think  
4 about it when I see people like Chuck and obviously  
5 Bryan and Supurna all using -- and some of the other  
6 technology firms here are all driving technology in  
7 this market, and with what ICE is doing to make  
8 electronic markets globally, what CME does with the  
9 Globex system, is utterly amazing. And obviously we  
10 can do so much more with technology. Supurna has,  
11 obviously, clients all over the world that she has to  
12 serve and document as a -- you know, where her firm has  
13 put money and where their funds are and how they are  
14 going to protect them. Everyone -- John has had  
15 clients, Chris has had clients, Gary had clients. So  
16 all of these -- and all of these are technology-based  
17 solutions going forward.

18           So I think the consensus, obviously, today  
19 was it can happen, it can happen now, and we have to  
20 move forward on it. I think what is really important  
21 is to focus on what the solutions and some of the  
22 nitty-gritty -- there are some questions here I have

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1 about, is it a push or a pull for this data? Does it  
2 matter? What about cyber security? Are we opening  
3 holes in bank -- to create bank exposure that other  
4 people can use to get access?

5 Not only do we have to protect customers from  
6 fraud, we also have to protect them from the next  
7 fraud. And that is a technology-based fraud, that's a  
8 cyber threat, and we need to think about that as well.  
9 So I hope, you know, can do away with the fax machines,  
10 we can do away with the post office boxes, but the next  
11 threat is obviously going to be a cyber threat or  
12 something like that.

13 So as technology moves and innovates and we  
14 use better protections -- and, Alun, you know, these  
15 are kind of in your wheelhouse, and, Chris, you as  
16 well. How do we use technology to protect against  
17 other technological threats going forward?

18 So these are some of the questions that I  
19 hope to have. I really want to have the experts at the  
20 table. I have had my -- I have been able to ask  
21 questions, and the Chairman has asked his questions.  
22 So I want a free-flow discussion among the experts. I

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1 will call on Gary next to get us started this  
2 afternoon. He has been very patient all morning  
3 without the light going on.

4               So I am going to -- you know, let's recognize  
5 -- let's have a discussion. I will just sit here to  
6 recognize people and kind of maybe refocus it a little  
7 bit and drive it. But so those are some of the  
8 questions I have. How do we get -- how are we actually  
9 going to implement it, broad framework? Gary, please.

10              MR. DeWAAL: Thank you. And, again, it is  
11 always enjoyable, and I think this is one of the very  
12 useful forums that the Commission hosts. And so thank  
13 you, Scott, for hosting this and being such a, you  
14 know, diligent expediter of these discussions.

15              You know, again, I think some of you have  
16 heard me say this in the winter -- the winter TAC, I  
17 forget whether it was in February or March -- heard  
18 about these ideas, listening to these ideas about daily  
19 reconciliations occurring at some SRO. In fact, we do  
20 that every day in our JV and China.

21              SIPIC (ph) Newedge, under the auspices of  
22 CSRC, is a member of the China Futures Margin

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1 Monitoring Center, and every day we do today what is  
2 being suggested for the United States. Every day we  
3 provide records to CFMMC related to the equivalent of  
4 our segregation calculation, and we provide backup  
5 access to documentation.

6           In fact, in China, it is the CFMMC that sends  
7 out customer confirmations. It is not the brokers  
8 themselves, interestingly enough. That's not something  
9 I would recommend adopting, but that's how far the  
10 system goes there. And every day the depositories  
11 where we have our clients' funds provide access to  
12 CFMMC. And every day CFMMC does a reconciliation  
13 between what we say we are supposed to be segregating  
14 for our customers versus what the depositories say they  
15 are holding.

16           And, again, it is a far, far less complicated  
17 system. The options of where we keep our money are far  
18 less advanced, and so you just can't take that system  
19 and transplant it here easily. But in fact, as  
20 Commissioner Chilton suggested, we can look abroad and  
21 see this system working every day as it has been for a  
22 number of years, because, unfortunately, China

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1 experienced the same type of issues as MF Global and  
2 Peregrine prior to 2006. And that's why CSRC ordered  
3 the creation of CFMMC.

4           It is an entity owned by the four exchanges  
5 in China. We did make a submission back in March to  
6 the Commission. We included -- and it's online, I  
7 checked it yesterday -- both in Chinese and English  
8 there's a presentation of CFMMC describing this system  
9 in our cover letter. So I do recommend that as part of  
10 a study of the system that everybody who is looking at  
11 this actually look at a system that is today working  
12 every day. So it is not theoretical; it's actual.

13           The other thing that I think is very, very  
14 important as this debate goes forward -- and, again,  
15 firms like Newedge, and certainly I believe all of the  
16 top 10 firms holding customers' segregated funds, are  
17 combined broker-dealer FCMs.

18           I am very, very concerned about any system  
19 that only looks at one side of the ledger. Right now,  
20 we have five potential buckets for customer funds,  
21 three on the futures side, two on the securities side.  
22 And I think that any solution that only solves half the

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1 ledger is an issue, because the fraudsters know how to  
2 do arbitrage. And if the system is fixed here but open  
3 there, you can be sure they will be figure out how to  
4 do the fraud there.

5           And I think this is an excellent opportunity  
6 for the Commission to work with the SEC. The SEC  
7 methodology for -- they call it reserving customer  
8 funds instead of segregation. There is a reserve  
9 calculation that we perform. Even the approach is very  
10 different. You know, effectively, when we receive  
11 customer funds on the security side, we are not  
12 depositing it until potentially a day or even later in  
13 a seg bucket.

14           Custody and control is different. The way  
15 they look at money and the way they look at securities  
16 is different. And I think that, you know, once and for  
17 all, you know, the SEC and the CFTC are going to have  
18 to look at the way customer funds are protected and see  
19 if we can harmonize it, because, again, I think if we  
20 don't there is an issue.

21           And I am also very sensitive to the issues  
22 you raise about 30.7. And, again, I think it was March

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1 2011 IOSCO published a survey of all of the principal  
2 customer protection regimes around the world. And I  
3 know a number of us, you know, dusted it off post MF  
4 Global. And I was really struck with how differently  
5 funds are protected from jurisdiction to jurisdiction.

6           There are jurisdictions that absolutely  
7 prohibit brokers from topping up customer funds. And  
8 then there were those, like the United States, that  
9 encourages topping up customer funds on the futures  
10 side. Okay? Not necessarily on the securities side.

11           I think that we are never going to solve 30.7  
12 until there is, again, a greater harmonization or a  
13 greater desire to see if there is some potential  
14 harmonization, you know, among the customer protection  
15 regimes. But I am not optimistic realistically. And,  
16 again, that is because insolvency law is so different  
17 from jurisdiction to jurisdiction, and in many ways  
18 insolvency law is what drives customer protection in  
19 the first instance.

20           With that being said, I do think we can get  
21 better. And I think the type of leadership that you  
22 are showing here, and the Commission is showing post MF



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1 Global and Peregrine, is something that needs to be  
2 replicated around the world. I am actually surprised  
3 that I haven't seen more push by other regulators  
4 around the world to reexamine the way that customer  
5 protection is handled, because, you know, I have been  
6 around too long, and, you know, but for the grace of  
7 God there go I.

8           You know, we may hit a bad streak here, but  
9 it is going to happen somewhere else sure enough later.  
10 I think this is an opportunity for all of the  
11 regulators, perhaps under the umbrella of IOSCO, to  
12 really take a hard look to see if there are some  
13 principles that could be seen. And one of that may be  
14 the access to the ultimate depository accounts, the  
15 access to the segregation computations, the daily  
16 comparison. So that if you in fact just take the feeds  
17 from the first level of the 30.7 funds, the brokers in  
18 London or the brokers in the Singapore, you have some  
19 satisfaction that at least a local regulator is looking  
20 behind there. Today I don't think that is the case.  
21 Today I don't think that is the case.

22           So, you know, those are some of my thoughts.

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1 I mean, again, I echo what Mike said. I mean, you  
2 know, I've been around a long time. I heard the  
3 debates when I first entered into the industry. It is  
4 literally just about the time of the "Why Investors  
5 Matter," and it was then that the customer insurance  
6 was being looked at and a study was done by NFA. And  
7 then, we really haven't heard about this subject for 25  
8 years.

9 I do think it is worth looking at it. I do  
10 think we have to consider that. And I know a lot of my  
11 colleagues won't like what I'm saying, but, you know,  
12 the train is coming, and the question is whether you  
13 want to be run over or be on the train. And I'd prefer  
14 to be on the train. The question is, it's a hard  
15 topic. It's a hard topic how to fund it. I'm not sure  
16 that SIPIC would have been able to adequately cover the  
17 entire amount of the MF Global loss. And what would  
18 that mean?

19 And I think it -- but we've got to look at  
20 it, and I think the suggestion that Mike has made is an  
21 excellent suggestion. If IFM or some other entity can  
22 start the study, I think that's a really good thing.

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1           You know, individual customer segregation,  
2   yeah, I think it should be looked at also. I think,  
3   obviously, there are going to have to be amendments to  
4   the bankruptcy laws to tolerate it. Third party  
5   custody relationships sound like a great idea, except  
6   that I'm not sure what protection they ultimately  
7   afford customers because of the principle of pro rated  
8   distribution.

9           But that being said, I also think that the  
10   Commission is going to have, as you say that, you know,  
11   you solve one problem, but you create another problem.  
12   You know, there is going to be an interesting issue of  
13   equity with -- if some customers are able to buy  
14   individual segregation, it means that the remaining pot  
15   is going to be less. And instead of customers  
16   receiving 71 percent, they are going to get 45 percent.

17           And, you know, that is going to, you know,  
18   create issues of policy that are going to have to be  
19   discussed. So, you know, again, obviously complicated.  
20   You know, the steps that the CME and the NFA have taken  
21   are good, and, you know, the steps that firms have  
22   taken, you know, for our own clients. You know, we

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1 issue something called an AT 601, which is similar to  
2 the old SAS 70, a statement of internal controls. And  
3 I think the clients who got that from us were pretty  
4 happy.

5           You know, but it is a date in time. It says  
6 our internal controls up until the date it was issued  
7 were fine. The problem is, the date they received it  
8 was not the date that was covered. So it gives you  
9 some protection, but, again, I don't think anything is  
10 going to beat the online record. I don't think  
11 anything is going to beat the daily, you know,  
12 comparison of what we think as opposed to being said,  
13 what we are saying as opposed to being said, versus  
14 what is actually there.

15

16

17           And I agree absolutely with what Chris has  
18 said. Let's not try to, you know, do everything at  
19 once, because you won't do anything. We can start  
20 pieces by pieces. We can do -- we can do real time.  
21 We can do top day. You know, we will figure out a way  
22 to deal with the open trade equity from the exchanges,

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1 given the fact that there has got to be, you know,  
2 daily balancing of issues like that. But let's at  
3 least start doing what we can do.

4           You know, I am always struck when I think  
5 about the debate about this is that, you know, every  
6 day I've got a from all my personal accounts going into  
7 my Quicken software, and I press a button and, boom, I  
8 can see theoretically what I think I have is in fact  
9 what I have. And it seems to me that the regulator is  
10 overlooking the billions of dollars in customer funds.  
11 And to have at least the equivalent capability I have  
12 on my own personal Quicken, that just seems a minimum  
13 standard.

14           COMMISSIONER O'MALIA: Steve, maybe -- you  
15 don't have to do it right now, but give some thought to  
16 this, how we harmonize. I think Gary brought up a good  
17 point with the SEC seen with FINRA (ph). They are  
18 self-regulatory. And if you have thoughts now, by all  
19 means, but give it a moment and --

20           MR. JOACHIM: Well, I think the answer is to  
21 start the dialogue. And I think Gary is 100 percent  
22 right that we have to look across the industry before I

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1 can ask some of our staff to do a comparison between  
2 some of the proposals here and what the -- what we are  
3 doing on the securitized side. And there is clearly  
4 very, very different approaches in terms of these  
5 things. We are dealing with different instruments and  
6 different structures, so there should be justification.  
7 We should rationalize the differences, because what  
8 happens here could happen tomorrow on the securitized  
9 side, and it is really good to do that.

10           Although I will also agree with what Gary  
11 said, that you need to get started, and it is more  
12 important to at least start this process here and bring  
13 the SEC along during the process as much as possible.

14           COMMISSIONER O'MALIA: Alun, if you could  
15 respond to that cyber --

16           MR. GREEN: Yeah, absolutely. I'll respond  
17 to a couple of the things. I think your first  
18 question, Commissioner, was on the push or pull. I  
19 think it is appropriate when you've got your personal  
20 Quicken account for that to be a pull. You know, I  
21 think that people there have different needs as to how  
22 often they want to see that updated. But I think with

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1 what we're looking at here, we really would want this  
2 to be a push system. I think that you would want  
3 everybody who is submitting information into whatever  
4 entity it is that is going to collect this to be doing  
5 that on a push basis.

6           And I think that is going to evolve. You  
7 know, it is going to evolve in two ways -- firstly, in  
8 terms of the people who are able to, you know, push  
9 that in in an automated fashion. That is going to take  
10 time. Maybe it can start off with the cash with the  
11 information from the FCMs themselves, with the  
12 information from DCOs, and then we may need to more  
13 slowly expand our into some of the other depositories.

14           But the other way that it is going to expand  
15 over time is with the move from the batch to the real  
16 time. I think it is very important, as we start to put  
17 this in place, I completely agree with what Chris said  
18 in his opening remarks, a batch system is how many  
19 things are happening today. And that is certainly how  
20 I think we are going to have to start this off.

21           But increasingly we are seeing in the swaps  
22 world that real-time views of this are becoming very,

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1 very important. I think that the same will be true in  
2 futures, too. So we should definitely have in mind  
3 that we are going to be seeing an evolution from, you  
4 know, more of a batch process to more of a real-time  
5 thing. So that's why I see sort of push-pull.

6           With regard to guarding against the  
7 technology fraud, I think there are two different sides  
8 to it. And, actually, I think Chris at the other end  
9 is going to have quite a bit to say on that, too. With  
10 regard to how we look at it, all of -- or most of the  
11 connections that we have with our customers, with the  
12 DCOs that we work with, are over a secure part of the  
13 networks. So very, very little, if anything, that we  
14 put in place goes over any kind of public network. It  
15 all comes over our own private global networks.  
16 Anything, in fact, that does go over the internet goes  
17 over, you know, very secured lines with EPM tunnels and  
18 secure protocols on top of that.

19           So, you know, one element there is that you  
20 are ring-fencing the network. You are making sure that  
21 it is not part of the public internet domain.

22           But the other thing, you know, that is



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1 certainly appropriate for, you know, the players that I  
2 have mentioned -- the big custodians, the FCMs, the  
3 DCOs. You know, they are all certainly going to have  
4 the capability to connect in that way. But I think I  
5 would actually pass over to Chris at the other end,  
6 because I think that this, you know, guaranteed  
7 confirmation and security is probably, you know, maybe  
8 a little bit what you guys have got.

9           MR. SCHELLHORN: Yes. Certainly, I think,  
10 you know, from our perspective, I understand the whole  
11 discussion of push-pull. We're a little less I guess  
12 concerned about that. From our business, we could  
13 react to either. The biggest challenge is I think,  
14 Alun, as you alluded, is bringing some of those players  
15 along. Big or small, their willingness to react with  
16 technology resources is many times the challenge. And  
17 that is something we will just have to I think deal  
18 with based on some regulatory oversight.

19           MR. GREEN: I think it's probably worth just  
20 following up on that as well. You know, I sympathize  
21 with some of those banks, you know, and -- or whatever  
22 institutions, those depositories are meeting those

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1 technology challenges. You know, we are being asked by  
2 our customers to implement huge, massive changes to our  
3 systems as the result of not only the Dodd-Frank Act,  
4 but some of the other rulemaking that is coming  
5 through. And we totally support it, you know, as do  
6 our clients. But it is a huge amount of work.

7           So I think we shouldn't underestimate what is  
8 involved there. But the extent to which these things  
9 can be standardized and centralized always makes it a  
10 lot easier. You know, we felt on implementing gross  
11 customer margin, for example, that just getting the  
12 industry together with the various technology providers  
13 and the DCOs, and then extending that out with the help  
14 of the FIA to the FCM community, we were able to get a  
15 framework that was not only meeting the rule, but a  
16 little bit easier for us to implement from a technology  
17 perspective.

18           So when you move these things, you know, from  
19 some kind of regulatory oversight, as opposed to the  
20 market forces, it does sort of force the community to  
21 come together and can make things easier. So whether  
22 that means, you know, a rule from the Commission or,

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1 you know, a leadership from the NFA or the CME, I'm not  
2 sure. But I think that the extent to which it becomes  
3 mandated does actually make the technology solution  
4 easier.

5 COMMISSIONER O'MALIA: On that point, I mean,  
6 we obviously have the two largest SROs in the room.  
7 And both of them are saying -- using confirm, are  
8 saying the same things in terms of technological  
9 innovation. What is the timing that we need to be  
10 thinking about here? I mean, we've got all -- we've  
11 got banks, we've got FCMs, we've got SROs here. How  
12 does this all come together, and what is the  
13 expectation in terms of timing to get this into a  
14 better place than we are today, and then ultimately in  
15 this real-time space that we are evolving to?

16 MR. HEHMEYER: Well, with regard to the  
17 system that I described this morning at NFA, I think  
18 when it comes to the nature of the technologies and  
19 push-pull, I think that what we have envisioned, which  
20 was, I mean, weeks ago a discussion and now it has  
21 moved into something that is being planned, there is a  
22 number of accessible technologies that NFA can use to

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1 take the information that is gathered every day from  
2 clearing and non-clearing FCMs, the seg information.

3           As I said, we can very quickly move to either  
4 e- confirmation or online confirmation manually to  
5 check balances. But what we want to be able to do is  
6 to have the data go into a system and then the  
7 databases -- which we are going to quickly get over my  
8 head -- but then we want the ability to go out and  
9 confirm that what -- the balances that are in the  
10 information that has come in, go out and reach and  
11 confirm that the balances are there.

12           Certainly, clearing organizations and banks  
13 are much easier to confirm than other categories of  
14 custodians or other good seg locations, and certainly  
15 complications with 30.7 that get beyond a portal or a  
16 view to the rest of the world. But we should move  
17 ahead with the easier part first -- build the databases  
18 of getting the information in, build the technologies  
19 to go and confirm, which is the vast majority of the  
20 seg funds that are here and certainly would have caught  
21 the Peregrine thing.

22           So when it gets to a timeline of how fast NFA

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1 could build something like that, as I said, the -- I  
2 think the political will -- I used that term earlier --  
3 this is my take. It was not there, and there wasn't  
4 the urgency for it. Now that we have really sort of  
5 focused on this and started to think about, okay, what  
6 would that cost, how long would it take, I'm not  
7 prepared to do that here today. But we are rapidly  
8 having discussions about -- we are currently having  
9 discussions and rapidly ramping up our picture of how  
10 long that will take.

11 And Commissioner Chilton contributed today by  
12 saying, "Just do it quickly, please." And we get that  
13 loud and clear, and I think our organization did.

14 And NFA is in a very good position to do  
15 that, because we collect all of this data even from the  
16 non-clearing FCMS --

17 COMMISSIONER O'MALIA: Right.

18 MR. HEHMEYER: -- Mike Durbin (ph), right,  
19 and a lot of others that are in the ag communities and  
20 such. And so we get that information -- that seg  
21 information now, and we can certainly confirm the banks  
22 relatively easily. That isn't super sophisticated

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1 technology that we are talking about.

2 I hope that answers your question. You know,  
3 that is confirming with the banks. One thing I will  
4 say about your Quicken account is the bank sees that  
5 that money is in the bank. The money is not really in  
6 the bank. They have lent it to people to build  
7 buildings. And so this is a little bit of a different -  
8 - the nature of this is different.

9 It's not a criticism of the banks, but the  
10 depositories that have the money in cash, whether it's  
11 the DCOs or bank depositories and broker-dealers that  
12 are relatively easy also -- we can do that. I think  
13 that's doable, and pretty fast. How fast? I wish I  
14 could tell you, but I don't know.

15 COMMISSIONER O'MALIA: Bryan?

16 MR. DURKIN: We are, you know, very much  
17 aligned with the NFA on this whole initiative. So I  
18 think one of the things that, you know, we also have to  
19 work towards is, you know, parity in terms of how we  
20 are expecting information to come in from our customers  
21 and our clearing firms. And so I think the efforts of  
22 the SRO, you know, Subcommittee has definitely, you

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1 know, borne a lot of fruit, and hopefully that came out  
2 this morning in terms of things that we have  
3 collectively as an industry pursued.

4           No "Is it the answer to all of these  
5 questions?" You know, not in the least. But, you know,  
6 I can tell you from the CME's perspective it is top  
7 priority to us to be able to move forward on the  
8 initiatives that we talked about today.

9           COMMISSIONER O'MALIA: James?

10           MR. ROWEN: Commissioner, thank you. I guess  
11 the first question from a renaissance approach to  
12 technology is, are we comfortable with the process,  
13 right? Technology is an enabler. And what I don't get  
14 a sense is that the process is nailed down. What we're  
15 doing is it seems that we are looking to build the  
16 regulator the tools to do a better job.

17           The question is: do you know what those  
18 tools are? Because it seems we are going to move  
19 toward an exception-based review. We don't -- you  
20 don't have unlimited resources, and you are going to  
21 develop some filters that are going to say, "Okay.  
22 This needs further examination." Exception-based

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1 reviews are very problematic. They have a lot of false  
2 positives. They can be manipulated. You can basically  
3 balance books, so it will just pass through.

4           So the question I would have is, your tools,  
5 your needs have to be developed in concert with the  
6 process. The process has to be evaluated to make sure  
7 that there are no holes. I have heard that we are  
8 taking certain parts of the process and putting a lot  
9 of work behind it to automate it. Unfortunately, when  
10 you take individual components of a process and  
11 automate them, it creates gaps.

12           And here would be a perfect example. If we  
13 are not sure if we are going to go for full segregation  
14 or not, the technology needs for full segregation are  
15 very, very different than more of a consolidated  
16 approach. It is just -- it is more horsepower. It is  
17 more technology. It's more feeds coming in. And the  
18 thought will be is, if you have one feed that doesn't  
19 get to where it is supposed to go, it could render part  
20 of the examination or review not worthwhile taking a  
21 look at, right? All of the files have to be in at the  
22 same time.



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1           So the way renaissance normally takes on a  
2 project like this -- it is -- I think we all know this  
3 -- is you make sure that the process is bullet-proof.  
4 This is the process you want to automate. Okay? And  
5 then you say, "We are going to move forward."

6           Now, we could talk about insurance. But when  
7 is the most expensive time to buy flood insurance?  
8 It's after a flood, right? We've had a flood. So the  
9 question is, it's expensive because there's a lack of  
10 confidence in the system. And my thought would be as -  
11 - on the buy side is, oh, we're going to throw in  
12 insurance, so the pedal -- the foot can come off the  
13 pedal. We can take a little bit more time, and maybe  
14 the sense of urgency is no longer necessary. Again, I  
15 think the insurance should go along with it. I think  
16 it will go down as processes improve and time elapses.  
17 But we need to demonstrate as an industry that we have  
18 got a process that is worthy of automating.

19           And so when I hear the different components,  
20 I really want to go back to the folks who are going to  
21 use this data, find out how they plan on using it, what  
22 tools they need, what filters they are going to put in,

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1 and make sure that from the very beginning that  
2 information that comes down the pipe will meet their  
3 needs, because the last thing you'd want is to spend  
4 \$500 million or \$1 billion, sit down at your computer  
5 and say, "I'm going to review the first hundred  
6 exceptions," and the first 99 of them is because a file  
7 didn't come in.

8               So I just want to be cautious about saying,  
9 "Let's move forward" without you signing off on --  
10 someone has come to you and said each part of this  
11 process -- detection is the best deterrent, right? Has  
12 been signed off, and someone has thought about all of  
13 the ways this could be manipulated or -- and around.  
14 And at that point, then put it out for automation.

15               So that is kind of where we come from for the  
16 whole process is we don't start automation. In fact,  
17 automation doesn't take as much time as the netting of  
18 the process. Automation is something that will get  
19 done once we are very comfortable that the process  
20 meets the need.

21               COMMISSIONER O'MALIA: Bob, you had a --

22               MR. GARRISON: Well, I have two things I

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1 guess. One is I would just reiterate what Jim said, and  
2 I was struck by what I think Mike said, that, you know,  
3 understand the segregation calculation before you  
4 build. And I think it's important to make sure that you  
5 do go through the process of understanding what it is  
6 you are after and actually define in a very formal way  
7 the requirements.

8           I think until you do that, it will be very  
9 difficult to understand, you know, how much or how long  
10 it will take and how much it will cost to build it.  
11 Otherwise, you will end up in a situation where you are  
12 continuously adding requirements to what you are trying  
13 to build, and it will extend the time of delivery.

14           I think the second thing I'd say, again,  
15 getting to the requirements -- and I've thought about  
16 it as it relates to the Quicken comment and also your  
17 comment this morning about, you know, seeing your  
18 balances on your mobile phone -- in both of those  
19 situations, you know, you two were the end customers.  
20 And what we talked about this morning seemed to be a  
21 two-way reconciliation between, you know, the FCMs and  
22 the depositories. And I'm just curious to know whether

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1 the customer view needs to be factored into that  
2 reconciliation as well.

3           You know, I don't know the process well  
4 enough, but I would think that potentially fraud could  
5 occur by, you know, an FCM sending out customer  
6 statements to their customers that didn't reflect  
7 necessarily what was at the depository or at the FCM.  
8 And how do we close that loop off and do a three-way  
9 reconciliation where somehow the customer is brought  
10 into that process.

11           COMMISSIONER O'MALIA: Alun, you had --

12           MR. GREEN: Yeah. I think I've said --  
13 that's a very important point, and I think it is also  
14 closely tied to another gap that I just want to throw  
15 out the -- to SROs that Gerry brought up when he walked  
16 us through that statement, which his verification of  
17 the liability side.

18           You know, I think a lot of talk -- you know,  
19 a lot of work has been done on verification on the  
20 assets. But I clearly understand that that is where the  
21 fraud has occurred most recently. But, you know, if  
22 you close that loophole, they will look for the next

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1 one. So, you know, it strikes me that liability and  
2 verifying that liability all the way through from the  
3 client feed to the FCM to the DCO is really critical as  
4 we look at this. You know, that's why I put in -- the  
5 liability in -- on one of my four pillars, or two of my  
6 four pillars there.

7           And there is an issue there, particularly on  
8 the futures world, that you've got different levels of  
9 disclosure as you go along that chain in terms of the  
10 detail and that there is, at least at the moment, some  
11 netting that is going on there.

12           Now, the gross customer margin role is going  
13 to change that when that comes into play. But that is  
14 only going to change that for domestic exchanges and  
15 clearinghouses. So you're still going to have, you  
16 know, a more complicated situation on 30.7.

17           So I completely agree with both of those  
18 comments, and I think that what the SROs have got in  
19 place takes half of that, but it hasn't really looked  
20 at the other half.

21           COMMISSIONER O'MALIA: Chris, when you have  
22 this conversation about bringing all of this data --

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1 and, Bryan, same thing -- do the FCMs and the banks get  
2 together and talk about how they are going to confirm  
3 data? Or do you go to the banks and then you go to the  
4 FCMs and say, "This is how we want it"? Is everybody  
5 in the room having that discussion? Or are you just  
6 telling them, "Deliver it today, and I want it gift  
7 wrapped"?

8 MR. HEHMEYER: Well, I guess I was -- we  
9 haven't set up a formal process to review this. And  
10 certainly in business requirements and project  
11 management and all of those things, all of those things  
12 that were just described all have to be done. I  
13 completely agree. And NFA is pretty good at that. NFA  
14 has the data from firms coming in now.

15 So I don't -- I mean, CME could certainly do  
16 it, but they don't have the non-clearing FCMs data  
17 coming in. So we have the processes, and we have to --  
18 the technology people have to go through a serious  
19 review of the processes, and more time in the process  
20 than in the building, completely agree.

21 We have -- aside from Gerry and Mike being on  
22 our board, and numerous others, and a lot of input from

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1 the members, we have a lot of people that contribute to  
2 that. But on this particular project, I don't have an  
3 answer for you, because we are just beginning this.  
4 But we anticipate getting a lot of member input as to,  
5 particularly when we get into -- the banks I think are  
6 fairly simple, because of -- we've got some of that in  
7 place, and the online process is fairly simple. And  
8 the technology guys could probably answer that for you.  
9 I just don't -- I'm not armed with the answer myself.

10 But the more difficult questions of FCMs  
11 being good seg locations to other FCMs, particularly  
12 30.7, that's where we are going to need member input,  
13 frankly, is in those processes. And that has to be  
14 done before we begin building the technology. I agree  
15 with that completely.

16 COMMISSIONER O'MALIA: Mike?

17 MR. DAWLEY: Yeah, just a couple of thoughts  
18 here. And I think there has been some great comments  
19 over here about understanding what we are actually  
20 trying to accomplish. And I think a couple of  
21 questions that come to mind, we first have to  
22 determine, what is it we are reconciling or verifying?

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1 Are we verifying a particular bank balance or a  
2 custodial balance? Or are we verifying the seg  
3 calculation?

4           The seg calculation holistically is going to  
5 amount to something. Gerry's was \$3-1/2 billion, I'm  
6 \$28 billion, whatever the numbers are. At the end of  
7 the day, you know, that and capital are pretty  
8 important. And I think, you know, that's why I think it  
9 is really important to get into the weeds and really  
10 get a clear understanding as to what we want. What  
11 data is really most important? If you've got a firm  
12 who has got -- who has reported \$4 billion in seg  
13 funds, and the regulators go out and confirm that there  
14 is \$4-1/2 billion in all of the different depositories,  
15 plus they have \$100 million in capital on top of that,  
16 I think you can sleep at night.

17           Do you really need to delve into each  
18 individual line item and confirm it? Because I think -  
19 - I'm not saying we can't do that, but I think it is  
20 important to - - wow, look, there's two of them.

21           (Laughter.)

22           MR. CORCORAN: The regulators are doubling in



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1 front of us.

2 MR. DAWLEY: Right, right.

3 MR. KENNEDY: And it's the swaps market,  
4 right?

5 (Laughter.)

6 This is my brother, Rob Gensler. He works at T. Rowe  
7 Price. And as you might have gathered, we are twins.  
8 Hi, Rob.

9 MR. DAWLEY: We've heard some of the stories  
10 and mischief you guys have gotten into.

11 MR. KENNEDY: It was all legal, though.

12 MR. DAWLEY: Right, right, right.

13 MR. KENNEDY: And transparent. So I was just  
14 introducing him to --

15 COMMISSIONER O'MALIA: You know, CNBC  
16 yesterday -- Rick Santelli did a piece. It wasn't that  
17 favorable of me, but he did a piece yesterday about  
18 this Peregrine situation -- I guess two days ago -- and  
19 they then put up a picture of Chairman Gensler. But it  
20 was Rob's picture.

21 CNBC --

22 CHAIRMAN GENSLER: Right. It was my file

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1 photo from T. Rowe Price.

2 COMMISSIONER O'MALIA: -- ran with a picture  
3 of Rob instead of me, and Rick Santelli and a certain  
4 Senator was calling for my head. So Rob stood in for  
5 me for that.

6 (Laughter.)

7 It's good to have a spare. That's what my folks said.

8 (Laughter.)

9 CHAIRMAN GENSLER: It's the least I could do.

10 COMMISSIONER O'MALIA: I'm sorry, Mike.

11 MR. DAWLEY: No problem. So I don't know if  
12 you got my point. I mean, I think we just have to be  
13 careful as to what we -- how far we want to go or how  
14 far we need to go, right? I mean, once you get into  
15 the weeds and start doing line by line on that seg  
16 report that Gerry put up there, and some of them are a  
17 lot more complicated than that, there is going to be  
18 all kinds of false positives. And it would make it  
19 very challenging to identify a real problem.

20 So that is my point. I mean, let's just make  
21 sure we do the right analysis and make sure the data we  
22 are requesting and how we analyze it is really

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1 accomplishing what we set out to do.

2 COMMISSIONER O'MALIA: Pierre?

3 MR. LAMY: On that point, I would like -- at  
4 some point, no more participant site, we need to do --  
5 I am for real-time reconciliation. I don't know about  
6 that, because real-time reconciliation is very useful  
7 when you want to reconcile transactions, the activity  
8 that is going on. But if you focus on balances and  
9 positions, you really do not want to do it again,  
10 because this is where you get all the noise, because  
11 you have all of these transactions, and you will never  
12 equal in your balances and positions.

13 So I think it goes back to, what do we want  
14 to achieve? What is the process that we want to aim  
15 for? And then -- and for that, and not try to overcome  
16 and end up with something that may not work.

17 COMMISSIONER O'MALIA: Let me take you back  
18 to a day in October, late October, three days in fact  
19 in October in a certain -- MF Global. And I'll take  
20 issue a little bit with that, because that was money  
21 in, money out. And the money was constantly being  
22 turned over, and within three days \$1.6 billion was

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1 missing.

2           And, you know, when the music stopped, and it  
3 went into bankruptcy, there was money coming in and  
4 coming out on a regular basis. But when the music  
5 stopped, customers didn't have a seat at this table.  
6 And so I do think that we need to think about the real  
7 time in some respects, because of that situation.

8           MR. LAMY: We need to think but not to say it  
9 as an -- this goes back to the point that James was  
10 pointing out, which is let's define the processes and  
11 the technology will align to the processes. If we want  
12 to start by saying, "Well, let's reconcile position and  
13 balances," I don't think you want to do real time,  
14 because this is where you will end up with a lot of  
15 noise and that will not work.

16           If you want to say, "Well, no, I'm done with  
17 the position and balances, I want to go one step  
18 further and look at the activity," then you start  
19 loading activity and this is where you may want to do  
20 real time.

21           COMMISSIONER O'MALIA: So the positions and  
22 balances, T plus one was kind of where most people were

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1 saying, you know, but then have an activity -- maybe  
2 an activity report in more real time to show money  
3 flows, or at least be able to track money flows. And  
4 that way you can say, "Well, it left here and it" --

5 MR. LAMY: It will depend as to what we want  
6 to track and what the --

7 COMMISSIONER O'MALIA: Yes. The analysis and  
8 the movements match on a regular real-time basis,  
9 that's what you're saying is extraordinarily difficult  
10 real time.

11 MR. LAMY: Well, it is more difficult  
12 possibly, but also it is not effective to achieve  
13 something else.

14 COMMISSIONER O'MALIA: Well, balance is also  
15 a substitute for valuation as well, which I heard  
16 earlier today was a -- I think Gerry brought it up, the  
17 valuation of certain accounts and securities in certain  
18 accounts. That doesn't happen until the end of the day,  
19 so you can see transactions happening. Knowing the  
20 value of those at any point until the mark-to-market  
21 occurs is the challenge.

22 Mr. Bates?

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1           MR. BATES: If I could, Mr. Chairman, I would  
2 just like to say some of the presentations this morning  
3 - - I thought all of the presentations were very good.  
4 There are some particular things, but I want to pick up  
5 on this theme which I think was introduced first by  
6 Gerry this morning.

7           There's two issues which are around at the  
8 moment. One is the false positives, which James  
9 brought up, and Pierre has mentioned. And also, this  
10 issue about, can you do mark-to-market? Do you have to  
11 wait until the end of the day? I think that was first  
12 introduced by Gerry this morning in an excellent  
13 presentation.

14           By the way, Gerry, I didn't Tweet your  
15 presentation this morning. As I told you, Twitter was  
16 actually down when he was presenting, unfortunately, so  
17 technology -- it's so, so shoddy. So just a couple of  
18 points on that. I'll get to that in a second.

19           So the push or pull, which relates to this, I  
20 think you've got to aim for, you know, a push  
21 technology. That's the way of the world. But right now  
22 I agree with -- you know, I think it was Chris that

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1 said this morning, "We want to do something as soon as  
2 possible." So you can simulate sort of a push  
3 technology using agents to go out and continuously pull  
4 data, going around to all of the accounts.

5           Let's say the CFTC wanted to do something  
6 that Gary introduced this morning, and he said there is  
7 millions of accounts, you were asking millions of  
8 accounts out there, and so on and so forth. You can  
9 have our agents. You don't have to have humans. You  
10 can have software agents that are going to go out and  
11 continuously pull that data. And it is starting to  
12 simulate it, albeit in a more batch-oriented way, but  
13 it is more real time than just doing it once a day.

14           So you can start to put that in right now.  
15 There would be no reason you couldn't do that. I think  
16 that's a benefit. I think you would need to have rules  
17 engines that would look for the particular patents that  
18 were introduced. Alun was touching on this this  
19 morning.

20           And just on the false positives, that is a  
21 problem that we have seen in many industries. Whenever  
22 you've got an alerting system, the whole point is

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1 you've got human beings, you don't have many of them,  
2 so you don't have many guys in the CFTC that would be  
3 able to do this. And when I say "guys," I mean men and  
4 women of course, that would be able to do this.

5           So you want to maximize technology to  
6 actually maximize your human -- benefits of a human, so  
7 you only bring them in when they absolutely need to.  
8 That's where the false positives can get you, because  
9 they can be constantly spinning with some noise or  
10 people getting under the radar.

11           So the way that's handled in other areas,  
12 like market surveillance, for example, which is going  
13 real time increasingly, you get patents which might  
14 indicate things like, you know, insider trading or  
15 market abuse, quote stuffing, or whatever it might be.  
16 But they may be just somebody might -- it might not be  
17 insider training. It might be somebody who got lucky.

18           But if there's a consistent patent over a  
19 period of time, then that might be something you would  
20 then raise the level of alert to bring in a human  
21 being. So I am a big fan of not just being able to  
22 find the patents temporal logical but also piece them



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1 together into an audit trail, and then bring in the  
2 people. So you are sort of maximizing the people's  
3 time.

4           So I would -- and the more real time the data  
5 is, the more quickly you are going to be able to get  
6 those higher value alerts. So there is technology that  
7 can do that today. Alun was touching on that today.  
8 So I think that's very important. And Gerry raised you  
9 need human review.

10           On the mark-to-market point, if I might just  
11 address that one as well, I have also been involved  
12 with lots of systems. And Gerry said you can't do that  
13 until the end of the day. And I may be missing  
14 something here, but there is lots of people who are  
15 doing real-time mark- to-market, continuous mark-to-  
16 market, so they are constantly reassessing the value of  
17 positions.

18           And they are doing the same with risk. That  
19 is going increasingly real time. Although you can't do  
20 the heavyweight models you do at the end of the day,  
21 you can do a lightweight model to see, you know, what  
22 might be your value at risk.

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1           So I don't know why you couldn't do -- may  
2 I'm missing something -- why you couldn't assess those  
3 pieces that you said would be harder at the end of the  
4 day. I wonder if you could take a real-time approach  
5 to that.

6           So that's a couple of brain dumps for me, but  
7 great presentations this morning.

8           MR. CORCORAN: The real-time matchup is the  
9 problem. You need a snapshot in time to, what are you  
10 comparing your mark-to-market to? Because your books  
11 and records are traditionally on a batch process. So  
12 if a regulator is trying to take real-time data, what  
13 are they going to match it to? Right now we are going  
14 to be filing our seg reports daily. So that is what  
15 the -- you know, the regulators are going to try to  
16 match the data to.

17           And I would like to, you know, just throw in  
18 here that -- don't forget, this is a holistic approach  
19 that the industry is taking. And, Scott, in your  
20 example of the last three days of MF, you know, some of  
21 the rules that NFA Rule 16 would have put on the table  
22 is somebody at MF -- the CFO or the CFO would have had

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1 to approve that movement of seg funds, right? And I  
2 don't know if people would just go ahead and do that,  
3 but the match off here that we are talking about in my  
4 eyes is a deterrent. It provides a deterrent to  
5 fraudsters, and also early detection to fraudsters.

6           So I think we have to look at everything we  
7 are doing holistically. A lot of it is already done.  
8 What we're trying to do here with matchups is a  
9 deterrent and early detection of fraud. And whether  
10 you need to do that real time throughout the day I  
11 think -- I guess in a perfect world, yes. I just don't  
12 think we can get there based on books and records,  
13 which is on a batch basis today.

14           COMMISSIONER O'MALIA: Well, to the -- the  
15 prevention and the deterrence is the key here, that the  
16 reporting -- the Corzine rule is a great after. It is  
17 going to give our enforcement officers, you know, a  
18 great opportunity to say, you know, did you or did you  
19 not sign this? You know, that's great for bringing a  
20 case. It's not good for catching bad guys before it  
21 happened.

22           MR. SCHELLHORN: It just seems to me, you

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1 know, as you look at the challenge, to take small bites  
2 out of the apple. I mean, today, a point in time is  
3 more what certainly the financial institutions are used  
4 to dealing with. And you have tools that allow you to  
5 do that today, whether it's our tool or others. And  
6 they don't need to be once a year or once a quarter.  
7 They can be daily.

8                   And then you can I think migrate as you  
9 establish the rules from a transactional perspective  
10 where you want to dig down and build that application  
11 down the road. But at least at a minimum, to deal with  
12 a fixed point in time, balances are relatively easy.  
13 And so I really can I think align pretty much with what  
14 Gerry is saying on this one.

15                   COMMISSIONER O'MALIA: Go ahead.

16                   MR. LEWIS: I was just going to say that the  
17 -- you know, if you look historically at the way other  
18 -- historically, the '40 Investment Company Act, during  
19 the Depression there were all sorts of problems with  
20 pooled investments. They had a similar sort of  
21 problem. The '40 Investment Company Act took the view  
22 that they created an independent entity that did the

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1 valuations.

2           So that's where sort of the trust bank  
3 function came from in the securities market. So you  
4 don't trust the guys running it to do the valuation.  
5 Somebody does the valuation, holds the money, banks  
6 have to do it, because banks are the only guys with  
7 access to the payment system. So the structure there  
8 has worked very well in terms of the independence, you  
9 splitting those up.

10           Now, in the securities market, then in the  
11 '60s -- you take it fast forward -- before then it was  
12 somewhat like futures with fractured clearing. Even,  
13 you know, Board of Trade was a stock clearinghouse and  
14 stock exchange the day before they gave up the license,  
15 because they were afraid the SEC would give them  
16 trouble.

17           But the fact of the matter is is the industry  
18 then created utilities to bring it all together. And  
19 the reason for that was it was just an administrative  
20 nightmare. It was the number of securities that were  
21 running around was just prohibitively difficult. You  
22 know, they used to have a place under the East River

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1 where you'd put all the stock certificates. So  
2 eventually they worked out -- let's demutualize that.

3 Now, the key difference with the futures  
4 industry and the securities industry is the securities  
5 industry -- this is why insurance is really problematic  
6 is securities -- you basically have a security. So you  
7 can liquidate everything, see what is missing, and pay  
8 it off. Nobody has hard feelings, because all you  
9 really care about is the money.

10 That is not true in the derivatives, because  
11 in derivatives what you want is the position. So  
12 liquidating the position is the last thing you want if  
13 you are a user of the futures market. You want to keep  
14 the position open. And that is where the anomaly comes  
15 in between trying -- you can't harmonize some of this  
16 stuff.

17 Two other simple points. First point is, we  
18 are also -- I think you've got to be careful not to  
19 fight the last war completely. We are at a point,  
20 because of interest rates, where who cares about  
21 getting cash? All of us know that have been in the  
22 business a long time, this is really the exception

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1   rather than the rule.

2                   So the problems that you are assuming --  
3   yeah, you can check on the bank accounts.  Honestly,  
4   this is a trivial problem.  I mean, it's absurd that it  
5   wasn't done before.  It is kind of -- enough said.  But  
6   the real issue is, particularly as you go into more of  
7   the -- more products cleared, more sophisticated risk  
8   management products, the amount of collateral is going  
9   to get much larger.

10                  It's not going to be cash.  There are going  
11   to be all sorts of haircuts.  Realistically, it is  
12   going to have to be done on a batch basis, because the  
13   controls wouldn't work otherwise.  And I think it comes  
14   back to the trust banks.  I know we'd be happy to work  
15   -- you know, we talk to our customers about this, but I  
16   think -- I think it does come back inevitably to some  
17   form of tri- party custody as the only workable  
18   solution now.

19                  The final thing I'd say, which is a harsh  
20   thing to say, is I just worry that we are confusing  
21   different problems.

22                  Now, the problem of fraud is, particularly

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1 the most recent example, is one -- pretty  
2 straightforward. I think if people had been doing  
3 their job competently at NFA, frankly, it would have  
4 been detected years ago. I don't -- I just -- greatest  
5 respect to Chris and the guys there. And I think  
6 creating a whole new problem beyond just not doing what  
7 you did today with the existing tools you could have  
8 prevented, doesn't then argue for transforming  
9 everything.

10 But where I do think the question of overall  
11 positions become a problem for the industry is the  
12 trading activities. And, again, this comes back to the  
13 MF or the Lehman situation, because fundamentally the  
14 industry has a problem if the clearing firm goes under.  
15 There is no solution to that in the -- we thought there  
16 was in the bankruptcy, but we discovered there wasn't.

17 And I just think we should be up front,  
18 whether it's technology -- you know, I define  
19 "technology" broadly as a workable solution. There is  
20 a hole which you aren't going to fill with technology.  
21 Now, you can have technology so that Bryan or Chris'  
22 guys can identify rogue firms that are at the risk of



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1 going out of business. You know, and in fact that is a  
2 lot of what the surveillance activities do and has  
3 worked successfully.

4           And I think that is the focus that I would  
5 argue in particular is that the 116 FCMS have a  
6 comprehensive enough picture as the guys that are at  
7 risk of going down, and then a relatively small number  
8 of people can figure out if things are on the up and  
9 up. But I think even in the MF situation, you know, I  
10 would just ask a sort of hard question as to, you know,  
11 what were people doing?

12           And maybe the problem -- and then I really  
13 will shut up -- is back when I was a kid in Chicago, it  
14 was much more discretionary, you know, particularly an  
15 open outcry where obviously you had to watch -- you had  
16 a leg- breaker watch the local, right, if you were the  
17 clearing firm, you know? Is he trading too much? You  
18 didn't have any way to really find out what was going  
19 on, but so you had to substitute judgment -- the fact  
20 that you had skin in the game, and basically you would  
21 intervene and there would be, you know, social rules.

22           We are talking about this in the context of

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1 Peregrine, which is everybody knew in the industry  
2 there was something off about those guys. So what went  
3 wrong? Was it the lack of technology? I don't think  
4 so. I think that in fact maybe the automation and the  
5 bureatization (ph) and the legalization of all of this  
6 stuff has extracted the judgment element, which  
7 fundamentally is what you have to have, because there  
8 is point at which you've got have a judgment as to  
9 where somebody is over --

10 MR. HEHMEYER: I want to make sure I  
11 understand your question, because you are sort of  
12 talking about two things to me. One is whether or not  
13 NFA was doing its job. And as we've heard, 85 percent  
14 of the audits today are still done with --

15 MR. LEWIS: Paper.

16 MR. HEHMEYER: Now, I'm not trying to justify  
17 the NFA for having Generan (ph) Block, which it was  
18 very difficult for some of us that were around in '88  
19 to pick that particular firm. But there is not a  
20 harsher critic in the industry than Generan Block, and  
21 they are doing with -- we've got terrific outside  
22 directors, Mike Moscow and Susan Phillips and others on

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1 this independent committee. They are going to direct  
2 this study as to whether or not we are following  
3 standard account procedures and whether those are good  
4 or not.

5 We are going to find out, and if we need to  
6 make some cultural changes within the organization to  
7 try to get more focused on detecting fraud earlier,  
8 then that's what we will need to do. And we are  
9 prepared to do that.

10 For the -- it is an affront to my common  
11 sense that it took 20 years to find a fraud like that.  
12 If you talk to a lot of auditors, which I have done,  
13 they don't seem particularly alarmed by it. It seems  
14 that it happens all the time. But I am alarmed by it,  
15 and I am alarmed by it in CPOs as well, because  
16 sometimes we find these pools -- NFA probably brings, I  
17 don't know, 50 to 100 cases a year because some pool  
18 operator was spending the money. And it is more  
19 different than the seg, and I understand that. But  
20 that is one question.

21 For our industry, the harder point is is that  
22 the Federal Government up on the Hill has basically

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1 mandated huge amounts of collateral to come into our  
2 industry, and they have asked NFA to oversee a lot of  
3 the registration and some of the processes in there.  
4 That is a different question.

5           And so I guess I'm saying which one -- I  
6 understand the criticism about the 20 years. T plus  
7 one day is a lot better than T plus 20 years. I get  
8 that, and I -- we are going to get it to T plus one  
9 day.

10           I was -- we haven't talk much about Sentinel,  
11 by the way. When I was at Penson, we had money at  
12 Sentinel. Then, my trading company had money at MF, and  
13 Peregrine owes their trading company about five grand.  
14 So I'm the first one that found that it was in all  
15 three. Okay?

16           MR. LEWIS: Where do you put the money today?

17           MR. HEHMEYER: I mean, it was in all three.

18           (Laughter.)

19 If there is anybody out there, I'd like to get together  
20 and have a drink, because it is an exclusive club that  
21 I was in all three. So I get the outrage. That's a  
22 good question -- not Newedge, but -- exactly.

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1           And I get that outrage, and I'm all for  
2   trying to catch bad guys a lot earlier. Absolutely.  
3   And at NFA we have done three things. As I have told  
4   you, we have this study from Jenner of our accounting  
5   procedures and what went wrong. And we haven't -- and  
6   there is no excuse for -- excuse me, there is no  
7   evidence of NFA being complicit or looking the other  
8   way. We weren't -- somebody wasn't raping children and  
9   we were looking the other way. There is nobody that  
10   was complicit to the whole thing, not to pick on  
11   anybody in particular.

12           But, you know, the econ form stuff that we  
13   came across that we were using in the industry, which  
14   was new to the industry, it wasn't that he committed  
15   suicide -- some people I think have said he committed  
16   suicide and then we found out. It was because of this  
17   that he committed suicide. And now that we got the --  
18   or tried to. Now that we got the car hose out of his  
19   mouth, he'll leave incarceration feet first I think.

20           So we're out there catching bad guys, and  
21   we've got to get better at it. We've got to change the  
22   culture of the institution to detect fraud and prevent

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1 fraud earlier. Absolutely.

2 MR. TERRY: Hi. This is Marshall -- if I can  
3 speak. I'm on here in New York. My name is Marshall  
4 Terry. I work for Salisbury Capital, a small hedge  
5 fund up in New York.

6 COMMISSIONER O'MALIA: Marshall, can you hold  
7 on one second? We'll recognize you after Chris.

8 MR. HEHMEYER: I would just like to finish  
9 this point.

10 MR. TERRY: Yes, that's fine.

11 MR. HEHMEYER: Our industry -- because you  
12 made this point very well, Cliff, that the industry is  
13 being told that this collateral is coming our way, and  
14 we -- this industry needs to be well prepared to make  
15 sure that the buy side is comfortable with its money in  
16 this industry. And that's a different question than  
17 catching some bad guy that was -- you know, and \$200  
18 million is a lot different than Madoff's \$50 billion.  
19 We need to catch those bad guys earlier.

20 But trillions of dollars of deposits, I'm not  
21 sure how we are going to do that. I'm not sure if  
22 that's an NFA thing, that we can build an online system

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1 and check balances. And so is that more your question?

2 MR. LEWIS: It's both, and we agree.

3 MR. HEHMEYER: Okay.

4 MR. LEWIS: But I'm saying I think the bigger  
5 issue is the latter.

6 MR. HEHMEYER: Me, too.

7 MR. LEWIS: The more topical one is this  
8 crook in Iowa -- I agree -- which somebody should have  
9 found.

10 MR. HEHMEYER: We should have. I agree with  
11 that.

12 MR. LEWIS: That's a different question. But  
13 at the same time, let's worry about the coming new --

14 MR. HEHMEYER: So how are we going to do  
15 that?

16 MR. LEWIS: I think you are going to have to  
17 leverage the way the investment industry operates today  
18 successfully here for other than CFTC regulated  
19 instruments, a broad -- with allowing a range of  
20 choices. The unfortunate part is some of those choices  
21 work well for institutional investors and don't work at  
22 all for an individual farmer or speculator.

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1           And I -- and that's where your dilemma is.  
2   And you've got to accommodate both groups. The kind of  
3   client that -- you know, what Supurna needs is quite  
4   different than what, you know, an Iowa farmer is going  
5   to do. And that -- and the problem is that, to the  
6   extent that you take the client's skin out of the game  
7   completely -- well, we know what the consequences of  
8   that is going to be, too. That's not going to be very  
9   satisfactory either. I mean, inherently, there is  
10   risk.

11           I'm just saying that I think the next big  
12   risk is going to come from the clearing firm's overall  
13   financial viability. You are talking exponentially  
14   bigger numbers they are going to have to handle. And  
15   who is going to watch that. So I don't mean to doubt  
16   so much, but --

17           COMMISSIONER O'MALIA: Let me go to the  
18   phone. Marshall? Marshall, are you there?

19           MR. TERRY: I'm here, thanks.

20           COMMISSIONER O'MALIA: All right.

21           MR. TERRY: So I work for a small hedge fund  
22   up in New York. I am in no way a futures expert. But



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1 when I got the email from -- on this meeting, the first  
2 thing I did is I went and looked at the NFA site. And  
3 I looked at Peregrine, which is interesting today. If  
4 you look at the site, Peregrine is still approved,  
5 which is interesting.

6           So if the -- what I'm trying to do, say, from  
7 like a user's perspective looking into it, if I was  
8 that farmer in Iowa, you know, I like the fact that the  
9 NFA is thinking about these things, looking to import  
10 technology, so on and so forth. But at least what's  
11 available to me to kind of just assess whether or not  
12 the FCM is legitimate or not I think is somewhat  
13 lacking.

14           I mean, then I look at the Peregrine website  
15 today. It still says it is -- you are a member,  
16 board's firm approved notice for review registered. So  
17 that hasn't been updated, which is interesting. If you  
18 click through the regulatory actions, then you kind of  
19 see it, which is interesting.

20           But more importantly, when I looked -- as I  
21 talked to our auditors, we are already bugging them --  
22 when I first read the fact pattern on this. And, you

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1 know, what they -- what we do, frankly, we have to have  
2 an independent audit, and those auditors, you know,  
3 frankly -- I know this is not a high technology list,  
4 but they independently check with each bank relative to  
5 how much money is in the account, which is -- I think  
6 the gentleman before is -- that's a fundamental issue  
7 that seems to be overlooked here.

8           And I would argue that maybe if someone in  
9 the world of Madoff had done that, or, frankly -- I  
10 don't know enough about MF Global, but clearly in the  
11 case of Peregrine, we might not be on the phone right  
12 now. So I think it's great that we are making these  
13 initiatives towards better transparency and technology,  
14 but I do think -- I would be curious to know if there  
15 is anything just fundamentally being done on the front  
16 end of it.

17           The other thing I would add is this concept  
18 of -- I was talking to our accountant, and she has  
19 this concept of the health check, meaning that a farmer  
20 comes in and he picks Peregrine, you know, he or she  
21 has no idea what service providers that FCM uses to  
22 audit its books and records, so on and so forth. In

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1 other words, without showing any negative -- you know,  
2 to a smaller audit firm, but E&Y, from what I know of  
3 them, has a very comprehensive set of auditor  
4 procedures. Whereas, an auditor in, you know, a single  
5 shop in Iowa may not.

6           And those are the transparency issues I think  
7 if I was a farmer, again, sitting in Iowa I would like  
8 to know. It is much like in New York we have this  
9 health -- you know, this grading on food vendors.  
10 There is some, you know, matrix that is put together.  
11 I don't know if they'll run an algorithm, whatever it  
12 is. But it runs A through D. I know I'm not eating at  
13 D.

14           So just something on a little different side  
15 of the equation, meaning from a user perspective.

16           The only other thing -- and then I'll concede  
17 the point -- is with respect to this transparency  
18 technology list, having spent a lot of time in the OTC  
19 state, what we tried to accomplish there with respect  
20 to reconciliations was, you know, '08, '09, prior to  
21 that. Very, very similar type discussions.

22           And the solution that came out of the whole

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1 fed mandates, and what have you, this entity Charizol  
2 (ph) which sits in the middle, which is a utility.  
3 Although not a hub, it's a utility. The bigger issue  
4 is long-term liquidity. How do you actually scrub it?  
5 That's where that plays out today.

6 But I would suggest you look and you talk to  
7 folks that spend time in that state, because it -- you  
8 were trying to solve for a lot of the same issues,  
9 which we had all of these disparate systems that didn't  
10 speak to each other, and there was no interoperability,  
11 so on and so forth. Whereas, in the OTC station, at  
12 least you do -- I can go, and I do every day, look at  
13 all of my OTC positions at a position level, mark-to-  
14 market level, so on and so forth.

15 So those are my two cents on it. So I will  
16 concede and put down the phone at this point.

17 COMMISSIONER O'MALIA: Great. John?

18 MR. LOTHIAN: Yeah. I would like to take it  
19 back to just a 10,000-foot level for just a second.  
20 The presentations were great. The discussion is really  
21 good. But I have not heard anything yet that would  
22 reassure a customer and bring back confidence in the

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1 markets. What I have heard is a lot of catchup. Okay?  
2 We should have been doing this. We should have had  
3 electronic statements or access to this information,  
4 like I can get on a retail basis or whatever.

5 I have heard about the insurance, which I  
6 think is a good idea to look at, because, quite,  
7 frankly -- and as I mentioned the last time I was here  
8 -- the perception at the retail level, okay -- and  
9 believe it or not, there are retail traders -- and we  
10 have had two blowups of retail firms, which have had a  
11 substantial impact upon our industry, perhaps even  
12 greater than the level of participation that they have  
13 in our industry. Okay? So they are important to the  
14 ecosystem.

15 But those people right now are choosing not  
16 to trade futures. They are choosing to go into a  
17 security product, or go to a securities firm and keep  
18 their money in a securities account. And if they have  
19 to trade futures, they just move enough into their  
20 futures account to be able to margin that position, so  
21 it is up at the clearinghouse, and then they sweep  
22 everything back over to the security side.

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1           Now, you know, the market is moving. It is  
2 making up its mind. It is voting with its feet. That  
3 is exactly what is supposed to happen. We don't have  
4 to have securities and the futures necessarily be two  
5 separate worlds. You know, maybe this is where they  
6 are starting to morph into a single world, and the  
7 regulation will start to follow it.

8           But we are losing liquidity, which is a  
9 public good from our markets, because of this. And so  
10 we have to figure out a way to restore the confidence  
11 in our markets.

12           One of the things that Mike talked about  
13 being around a few years here myself, you know, the  
14 list isn't just MF Global and PFG, it is also Sentinel,  
15 it is also Revco. And this whole incidence here has  
16 basically torn away the scab that was Revco. Okay?  
17 And so it is fresh, in my mind at least, and so you  
18 have to say, okay, well, this would have worked on MF  
19 Global, but it wouldn't work on Peregrine, which begs  
20 the question, would it have worked at Revco?

21           Now, we are talking about doing all kinds of  
22 great things in order to help the audit process here.

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1 But the fact of the matter is that we had a fraud in  
2 this industry for 10 years with Revco that went -- that  
3 company went through a process of having a private  
4 equity investor with their money on -- you know, their  
5 skin in the game, buy into that firm and do an audit.

6           And then, we had that firm go through an IPO  
7 process and go through the rigorous IPO auditing.  
8 Okay? And it was only after the fact that it became a  
9 public company, and they had make a mistake that the  
10 error was found. Okay? Think about that. Cliff said  
11 they've spent \$10 million on all of the audits for  
12 Revco between the private equity and the IPO.

13           So are we going to spend \$10 million --  
14 that's \$10 million to be ineffective. Okay? We don't  
15 have that kind of money to spend on every single audit.  
16 Okay? So we need to be thinking bolder in terms of how  
17 to capture the public's imagination about the solutions  
18 to restore confidence. Technology is absolutely part  
19 of that, and I believe that. But the processes, as Jim  
20 pointed out, are really important, too.

21           We can't just go, "Oh, there's a company that  
22 offers confirmation, and so we are going to -- we are

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1 going to use this company now, and they are going to  
2 confirm that." The regulators could do the same darn  
3 thing. Okay? They just have to have the will to be  
4 able to do it, and they have to have the -- they have  
5 to have the training upon what to know with it.

6 I got up at 2:30 this morning to get here  
7 from Boy Scout camp in northern Wisconsin. I told my  
8 boys that -- just like the Scout oath says, that we do  
9 our best to do our duty to God and our country. And I  
10 was here today to do my duty to my country.

11 We, as an industry, did not do our best. We  
12 -- every one of us, as an industry, did not do our  
13 best. Whether it's the CFTC, the NFA, we are self-  
14 regulated industries. So that means it is our fault.  
15 It is our fault for electing the people that hired the  
16 people that did everything. Okay? So we are  
17 accountable to ourselves, and we need to find a way to  
18 restore this confidence in the markets or we are going  
19 to have a much smaller industry, and we are going to  
20 have a much smaller -- much smaller markets, and we are  
21 going to have a lot wider markets, and we are going to  
22 defeat all of the great work that we have done over the



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1 last 30 years in these markets.

2 So I will leave you with this one last thing.

3 David Roeder, who is a Sun Times columnist, doesn't

4 write very much about the markets anymore. But he had

5 this to say when he was talking about Chicago traders.

6 He said, "You know, you think of Chicago traders or

7 futures traders as these bright, colorful guys in

8 jackets and shouting and sweating and innovators and

9 all of those kinds of great things that -- you know,

10 that we have learned about." But he says, "What it

11 really is, it's full of wusses on the public dole."

12 Okay?

13 We as an industry don't fund ourselves at the

14 federal level. We depend upon the general revenues of

15 this great country of ours. Okay? I think that we

16 need to step up, and we need to help solve part of the

17 CFTC's funding problem, okay, which would help restore

18 some of the confidence in the markets by contributing

19 some revenues to the CFTC's budget.

20 I think that that would make a substantial --

21 a substantial argument that we have got some skin in

22 the game to improve the entire process. And if you had

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1 -- you know, I mean, the issue has always been we don't  
2 want a tax, a transaction tax. We don't want the  
3 Federal Government to have control over our pricing,  
4 and all those kinds of things. If it's the NFA  
5 contributing to the -- to a CFTC budget that they  
6 control what they are contributing, you still have that  
7 control.

8               We need a single solution across this  
9 industry for some of these problems. And that has to  
10 be a partnership of the NFA, the CFTC, some of these  
11 technology providers here. We need to make sure that  
12 we can continue to have FCMs come into this business  
13 and be part of this industry, that we are not just  
14 locking everybody out by putting up more barriers to  
15 entry, because, quite frankly, we are running out of  
16 players, particularly on the retail side. Okay?

17               So we need to make sure that FCM  
18 profitability is not absolutely negatively impacted by  
19 whatever it is that we do. And so, collectively, we  
20 have to do something to make sure that we are lowering  
21 the barrier for entry, so that we can have more  
22 competition in this business. Competition is what

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1 makes us better.

2 That's it.

3 COMMISSIONER O'MALIA: Mike?

4 MR. DAWLEY: A couple more comments. I agree  
5 with a lot of what John just said, and the emotions are  
6 running rampant throughout the industry. I think of  
7 Commissioner Chilton and his process of labeling his  
8 speeches with a particular theme. I think I would  
9 label this one "We're Mad as Hell and We're Not Going  
10 to Take it Anymore."

11 But I do think the emotions and all of the  
12 components of this and the advent of Dodd-Frank and  
13 cleared swaps and the size of the numbers that we are  
14 hearing are going to -- that are going to be involved  
15 are all causing a lot of frustration. And I think we  
16 need to back up and really identify, what is it we are  
17 trying to do? I said this earlier. We can't do  
18 everything, but we've got to do something tangible.  
19 And at the end of the day, FCMs are stewards for client  
20 money. And for the privilege of being a steward for  
21 client money, there has got to be proper oversight to  
22 assure that those stewards are in fact kept in check.

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1           And I have to go back to just focusing on  
2 what we want to accomplish short term. As stewards for  
3 client money -- and what happened in Peregrine and in  
4 MF, is money went missing -- what are we going to do to  
5 prevent money from going missing? We have talked about  
6 the electronic confirmation. Interesting idea. That's  
7 a component. But let's focus on, what exactly can we  
8 do?

9           And I go back to the very basic process that  
10 needs to occur here, or at least this is how it occurs  
11 today. You've got a segregation computation every day  
12 that is done by noon that says that you are a steward  
13 for X amount of money, and there needs to be a process  
14 that can confirm that that amount actually exists. How  
15 granular you get in that process is what we really need  
16 to delve into.

17           And I go back to, if you've got enough seg  
18 funds, and you've got capital, you are not going to  
19 have a problem. If your city bank account is shy a  
20 million dollars, but you've got a million dollars extra  
21 that you have invested in a money market fund  
22 somewhere, and you add up the two, you are still good.

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1 You are not going to have a loss.

2           So I just -- I would encourage us to really  
3 hone in on how we are going to verify the money that we  
4 are stewards for as FCMs and try and find a short-term  
5 solution. And the size really doesn't matter. Small  
6 firm, big firm, you know, there is no -- there should  
7 be no less diligence on a small firm. So yeah.

8           COMMISSIONER O'MALIA: Recognize Ananda  
9 Radhakrishnan, who is our Director of Clearing and Risk.

10           MR. RADHAKRISHNAN: Thanks, Scott. One of the  
11 things that -- there have been some great ideas floated  
12 in this meeting. But one of the things that I have not  
13 heard -- and picking up on what Mike said and what  
14 Scott said earlier -- you are stewards of customer  
15 money. And the outcome that I submit we need is we  
16 don't want people to move money where you shouldn't  
17 move it, right? That's the MF situation. They moved  
18 money; they should not have moved the money.

19           And it was very tempting to move customer seg  
20 funds, because it was there. The reason that money was  
21 moved was not as a result of futures trading. It was  
22 something else, and somebody pointed that out, right?

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1 A securities trade. But I needed money, so I moved the  
2 money from customer seg funds. So that is one.

3 In PFG, what you had was outright theft.  
4 There is no two ways about it. Outright theft. I am  
5 not making a determination, I am not saying this is  
6 what the CFTC is going to say, but, in my view as a  
7 citizen, it is outright theft. The guy stole money.

8 So how do you prevent somebody from stealing?  
9 How do you prevent somebody from moving money that  
10 should not be moved? And that is what I have not  
11 heard.

12 Now, you could say, "Well, make sure you are  
13 careful in who you hire." But I think most FCMs are  
14 careful in who they hire. But what I have not heard --  
15 and I guess the -- what I want to get to it is, what  
16 kinds of controls can FCMs have to make sure this  
17 doesn't happen? Or are you guys telling me that this  
18 is a pipe dream, that you cannot prevent somebody from  
19 stealing money?

20 I somehow don't think -- I don't know whether  
21 I accept that fact, that you cannot prevent somebody  
22 from stealing money.

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1           Now, Mr. Wassendorf, Sr. was the guy who got  
2 all the statements, and he is the only guy who dealt  
3 with the bank. You know, so obviously those were some  
4 telltale signs, right?

5           Let's go to what Cliff was talking about,  
6 which is third party custodial accounts. And Cliff is  
7 right, we didn't like the idea, not because -- I'm not  
8 sure it was because the FCMs lobbied for it, but I'll  
9 speak for the staff. Staff doesn't like the idea,  
10 didn't like the idea, because of the following. Banks  
11 are very famous for not paying when you want them to  
12 pay. Right? And with all due respect to, you know,  
13 Cliff's bank, we have seen that happen in Lehman.

14           So the way that staff has, if you have a  
15 third party custodial account, is the FCM needs the  
16 money to fund the margin call at the exchange, or fund  
17 the variation call. Customer doesn't pay or the FCM  
18 needs access to those customer funds at the bank. FCM  
19 goes to the bank and says, "Give me the money." In a  
20 third party custodial account, you've got somebody else  
21 involved, and that's the customer.

22           The customer gets a court order saying,

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1 "Don't pay the money." The bank is going to say, "I  
2 can't do anything." It would be awful if that resulted  
3 in a default by a clearing member to a clearinghouse,  
4 right? That's what we want to prevent.

5           Number two, FCM doesn't get a court order,  
6 but telephones the bank and the bank says, "Well, I  
7 don't know what's going to happen." Despite whatever  
8 promises the bank can make, the bank doesn't pay.  
9 That's the word, right?

10           So can we solve for that? If we can solve  
11 for that, then I think this whole notion of individual  
12 seg -- and I'm confused about the term "individual  
13 seg," because I always thought that at the firm level  
14 you must individually segregate funds. But you can  
15 commingle funds; the statute allows you to commingle  
16 funds for convenience. Are we talking about individual  
17 seg at the DCO level? What are we talking about? I  
18 would like to know what we are talking about. Is  
19 anybody here talking about not being able to commingle  
20 funds? No? That is not the answer?

21           Okay. So we are talking about individual --

22           MR. HURST: One of us.



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1           MR. RADHAKRISHAN: Okay. So you are talking  
2 about not being able to commingle -- despite what the  
3 statute says, that the FCM has to open separate bank  
4 accounts for each customer.

5           MR. HURST: Yes. If the customer is willing  
6 to pay for the additional cost, and some systems can be  
7 put in place that are shared by the industry, that's  
8 exactly what I'm talking about.

9           MR. RADHAKRISHAN: So that's -- I suspect  
10 that is something between the FCM and the customer,  
11 right? If the customer is willing to pay for --

12           MR. HURST: Yes. If some -- if the  
13 Commission will permit it. Right now, it is not  
14 permitted by the Commission.

15           MR. RADHAKRISHAN: I am not aware of that  
16 prohibition, but the statute says that an FCM can, for  
17 convenience, commingle customer cash and securities at  
18 -- so it is not clear to me that we have a rule that  
19 says you can do that, but we'll talk about it.

20           So let's go back to the original point. What  
21 can FCMs do to make sure this doesn't happen? For  
22 example, is it a case that the person who does the site

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1 computation cannot also be the person who moves money?  
2 Is that an example? Or does it take two or three  
3 people to move money?

4           So, you know, I'd like more of a discussion  
5 about what can the FCMs do, because I think if you are  
6 talking about preventing the kinds of things -- and we  
7 will never know what will happen the next time around,  
8 and I hope it doesn't happen the next time around. I  
9 hope there is no next time around, but, you know, I am  
10 not that nato think there will not be a next time  
11 around. Maybe not in our lifetime, but can we do to  
12 make sure that that doesn't happen?

13           Thank you.

14           MR. DeWAAL: You know, it has been a long  
15 time since -- I used to work for this agency as an  
16 enforcement attorney, so I'll go back to my old  
17 experience and my more recent experience. But,  
18 unfortunately, I don't think we are ever going to put  
19 an end to fraudsters. That is just the reality I think.  
20 I think police and agencies have been trying to do that  
21 for the life of humanity, and we haven't done a great  
22 job, and I don't think it is going to end tomorrow.

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1 I do think we can certainly try to eliminate  
2 as many of the encouragements of dishonesty as  
3 possible. You know, Cliff had talked about the fact  
4 that maybe it's not such a good idea to mix agency  
5 business and proprietary business. That happens to be  
6 the Newedge model.

7 You know, and then there were many clients  
8 who come to us because that is our model. You know,  
9 maybe whether it should be mandated as the industry  
10 model, don't know. I noticed that I think it was J.P.  
11 Morgan announced that they are forming a similar agency  
12 type organization within their unit, so that maybe that  
13 is going to be the trend of the future.

14 I know that when we first became a BD FCM --  
15 and this was back in I think it was 1987 -- one of the  
16 things that impressed me about NASD versus the security  
17 -- the futures self-regulators -- I think it changed  
18 somewhat since then -- is that the security regulators  
19 were much more concerned about our profitability. They  
20 wanted to know how we made our money, what the trends  
21 were, and they questioned us very, very specifically  
22 about that.

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1           And, obviously, I think that obviously a firm  
2 that is not making money is going to be more tempted to  
3 do bad things than a firm that is making money. So,  
4 you know, I think that you're right, you know, I don't  
5 think that it is possible to eliminate fraud, sadly.  
6 You know, but we can be more conscious, both from the  
7 overseers as well as from the structuralists, in  
8 preventing the temptation to do bad things.

9           But that being said, at the end of the day, I  
10 do think, you know, that, you know, increasing -- the  
11 increasing oversight, and increasing oversight through  
12 technology, is going to be a major part of the answer.  
13 I mean, the reality of life is there are just too many  
14 transactions that go through each of our firms each day  
15 to even think that you manually can keep track of these  
16 things.

17           Again, you know, if I was sitting on the  
18 other side of the table, I would probably be on a plane  
19 to Beijing tomorrow, and I would be looking at CFMMC,  
20 because they are doing what we are talking about today.  
21 They have been doing it since 2006.

22           My understanding is they haven't had a big

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1 issue since 2006, so maybe rather than keep guessing  
2 and figuring it out, we should see something that is  
3 working and try to emulate it as quickly as possible.

4           As I say from my own experience, because, you  
5 know, that is -- we are part of that system, it is a  
6 much more simplified universe. There is only four  
7 exchanges. There is no foreign 30.7 type stuff. There  
8 is a lot of limitations on where you can put your  
9 customer funds. So it's a much more, you know, less  
10 developed system than we have here. But, you know, we  
11 can certainly build on that.

12           You know, whether the answer is push-pull,  
13 you know, I agree with Chris. Let's start moving as  
14 quickly as possible with what we can do. If everyone  
15 around this table is agreeing that bank balances are  
16 something we could look at quickly, then we should  
17 start looking at bank balances quickly.

18           You know, again, in the CFMMC world, they do  
19 look both at the liability side as well as the asset  
20 side. They do compare the computation and segregation  
21 with the underlying statements. They do, then, compare  
22 the segregation with the depository. So they are

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1 looking at both sides.

2 as I said, it is not something I would want  
3 to emulate here, but it is, in fact, CFMMC that sends  
4 out the customer statements for all of the brokers in  
5 China. Brokers cannot send out their official customer  
6 statements themselves. You know, different approach.

7 You know, I do think a lot of what the  
8 industry has already instituted -- the Section 16 of  
9 the NFA rules, the CME ideas, I mean, there are  
10 improvements that we have made. The fact that people  
11 are now going to be looking at the pulling out of top-  
12 up money, the fact that, you know, other ideas -- these  
13 are things that I think will improve things tomorrow.

14 But, you know, again, you know, I don't know  
15 whether you were there, but, yes, I mean, there is  
16 going to be arbitrage. I remember when I first entered  
17 into this business, I went to an AML session somewhere,  
18 and somebody said at the time, they said, "Right now,  
19 there is a person out there who is studying the anti-  
20 money laundering procedures of Merrill Lynch, FEMAT  
21 (ph), J.P. Morgan, and Goldman Sachs, trying to figure  
22 out which one has the biggest hole, and they are going

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1   there.

2                   Okay.  These guys are smart.  Okay?  They are  
3   figuring out the weakness.  They are arbitraging.  If  
4   we fix our side and we leave open the reserve  
5   calculation, the fraud will happen on the reserve side  
6   tomorrow.  You're right.  I mean, for the BD FCMs, you  
7   know, to deal with one side of the ledger and not the  
8   other side to me is a big mistake, you know.

9                   But, you know, I don't want to -- you know, I  
10   hear what you're saying.  I am sympathetic.  I  
11   certainly don't believe we are ever going to end fraud.  
12   Okay?  But I don't think it is that dire.  I think, you  
13   know, we are -- we are making improvements, and I do  
14   think that technology is going to end up being a part  
15   of the answer.  You know, it is removing the temptation  
16   and improving your surveillance.

17                  COMMISSIONER O'MALIA:  Steve, and then Alun,  
18   and then Chris, real quick, and then going to Supurna.

19                  MR. HURST:  I just wanted to echo something,  
20   well, actually, that a lot of people have said.  Cliff  
21   said a mouthful when he said there is technology and  
22   then there is the judgment that lets you leverage the

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1 information the technology provides. That is a really,  
2 really important ingredient.

3 Mike is right about being a steward of  
4 customer funds, but it wasn't all that long ago that  
5 those stewards of customer funds were together sitting  
6 in boardrooms at clearinghouses before the exchanges in  
7 clearinghouses became publicly traded companies and  
8 they were able to exercise the collective judgment.  
9 That has changed.

10 One of the things John is calling for is, you  
11 know, more opportunities for the industry to come  
12 together and exercise that judgment. And one of the  
13 things that I think could happen -- and the DNA for it  
14 is in this room. Mike Dawley is former Chairman of the  
15 old Board of Trade Clearing Corporation. It doesn't  
16 exist anymore, but that is the model I am talking  
17 about. Chris Hehmeyer was part of that same  
18 organization, something like that. I don't know what  
19 form it is going to take but some organization like  
20 that that comes together and that has as its mission  
21 being a steward of customer funds, the organization  
22 itself that everyone is participating in, the way it



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1 used to be back in the day.

2 I mean, there were bad things about the old  
3 mutualized model, but in terms of risk management, you  
4 got the benefit of the collective judgment of the  
5 industry. And that is lacking today. Pardon me for  
6 being blunt, but when the first development occurred  
7 with MF Global, a lot of people said, well-intentioned  
8 people, "Well, gosh. You know, I guess that's what you  
9 get for hiring the cheap, low-end broker." That  
10 attitude would not have been allowed inside of those  
11 old organizations that people in this room used to run.  
12 And the reason for that is because the responsible  
13 people in this industry understand that if something  
14 like this happens, it reflects badly on everybody and  
15 they root it out before it blows up.

16 That mechanism doesn't exist anymore, and it  
17 should. And that is part of what I am advocating for,  
18 is that in some fashion, some group comes together in  
19 some central location that has one mission. And that  
20 is protecting customer funds, leveraging the technology  
21 but, most importantly, leveraging the passion and the  
22 skill and the experience that the people around this

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1 table have. And we're missing that today.

2 MR. GREEN: I want to tie together two or  
3 three things, but it all comes down to, can we prevent  
4 the theft. And I don't think we can prevent the theft,  
5 but what we can absolutely do is detect very early.  
6 And I think one thing we haven't talked a lot about is  
7 the amount of cushion that should be sitting there in  
8 the seg fund calculation. And assuming that there is  
9 some -- and I think most of the firms, obviously my  
10 colleagues, will know a lot more about it -- will hold  
11 a very reasonable amount of cushion sitting there. The  
12 first funds that you are stealing are your own firm's  
13 funds effectively, right? So you have got to work your  
14 way through that cushion before you start hitting into  
15 the true client- segregated funds.

16 So you can't prevent it, but I think that if  
17 you can detect it early, hopefully you can detect it  
18 before it truly hurts the client themselves and it's  
19 only the firm that is getting punished. But in order  
20 to detect it early, that comes down to the timing issue  
21 that people have been talking about.

22 And, you know, in the case of PFG, I don't

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1 know the details. I don't know that anybody does, but  
2 I would be very surprised if that money went missing  
3 overnight. And I think that that was an accumulation  
4 over a long period of time.

5           With MF, when we look at that situation,  
6 again not overnight but a much more reduced time frame.  
7 You know, I think you are talking about three days.  
8 And, again, we probably will never know exactly, you  
9 know, at what point they went under in terms of  
10 segregation, but clearly, you know, an overnight  
11 process is not going to be sufficient as we look at the  
12 industry in the coming 20 to 30 years.

13           So I really think that we have got to start  
14 to move towards something that is real time. Clearly,  
15 you know, batch processes are find as a starting point,  
16 but I don't think that you can regard it as being a  
17 daily process being able to protect going forward.

18           Now, another point about that. When we say  
19 "real time" or when I talk about "real time," it tends  
20 to mean different things to different people. You  
21 know, I think we have got people around the room who  
22 are in the algorithmic trading business for whom "real

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1 time" means, you know, microseconds. I don't think  
2 that's what we need to be talking about in this  
3 instance, but we do need to be talking about, for  
4 example, the way that a DCO will cull, where they will  
5 do intraday culls if there are significant market  
6 movements and do so on a regular basis, I think it is  
7 not unreasonable to say that whatever system we put in  
8 place has the capability that you can do an evaluation  
9 at any spot point during the day, not necessarily that  
10 you are always going to real- time reconcile, but if  
11 you have a reason to do so, that you can come in at  
12 noon and say, "All right. I want to have a look at  
13 what my position is."

14           Now, in order to do that, I think there are a  
15 few things. Mike's point about does it matter if you  
16 are a hundred million under in one account but you are  
17 500 million over, I think that is very valid, right?  
18 What you are really looking about is, where does that  
19 cushion sit. And so long as you are being very  
20 conservative in your reconciliation process, if you see  
21 that there are discrepancies but you are still  
22 protected, that is a much less issue than if you see

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1 that there are discrepancies and you are not protected.

2 So I think that is very important.

3           And then the other thing that I want to touch  
4 on is valuation of collateral. You know, we are  
5 talking about cash. Everybody seems to agree that cash  
6 is easy. There seems to be some dispute over how easy  
7 it is to do the same with securities. I don't believe  
8 it is particularly hard to market security at a  
9 snapshot during the day. You clearly need to have  
10 agreement on what pricing services are going to be used  
11 and what haircuts are going to be used, but I think  
12 they should be independent, both of the FCM and of the  
13 depository, so that you have got something that is  
14 standard across the industry. Particularly given the  
15 kind of collateral that it is that is acceptable under  
16 the secured, I don't see that there is any real serious  
17 issue in doing valuation. I'm surprised that some  
18 people here think there is.

19           You know, as well as our derivatives  
20 business, we have securities business, securities  
21 lending businesses, where we are, you know, very much  
22 looking at real-time movements and valuation of

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1 securities, treasuries, fixed income. So I don't see -  
2 - obviously there are barriers there. I don't want to  
3 pretend that these things aren't -- you know, haven't  
4 got devil in the detail. That is always there. But  
5 they are certainly achievable.

6           And I think that we need to very much think  
7 about whether that is going to restore confidence, to  
8 John's point. I really don't know. You know, I think  
9 that is a bigger issue. But I think to detect early is  
10 the only way that you are going to prevent. And, you  
11 know, all of these things are very valid, false  
12 positives, you know, the difficulties, but they have  
13 all been overcome. Whether they have been overcome in  
14 the TOC business, in the securities business, or, you  
15 know, we have Googled in their security and around all  
16 of their applications, plenty of people in technology  
17 have seen these issues before and overcome them. And,  
18 you know, half or many other firms are used to dealing  
19 with these.

20           So I don't think there are huge significant  
21 barriers that mean it can't be done. I think it is a  
22 will thing.

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1                   COMMISSIONER O'MALIA: Chris? And then we  
2 are going to go to Supurna.

3                   MR. SCHELLHORN: Yes. I will be real quick.  
4 I just wanted to react to Mike's comments. You know,  
5 from my perspective, the kinds of things that the CFE  
6 and the NFA are putting in place, you know, my  
7 colleague spends a fair amount of time studying these  
8 frauds that occur. And there are a lot of common  
9 elements, but certainly in the case of tools,  
10 validating balances, confirming balances on a regular  
11 basis, a daily basis, can be done today. And it  
12 certainly will go a long way I think moving in the  
13 direction of restoring investor confidence and  
14 something that could be done in the very near term  
15 while you work out some of the issues as it relates to  
16 some of the transactional activities you want to  
17 capture. And I think that is a signal that you might  
18 consider dissent.

19                  COMMISSIONER O'MALIA: Supurna has prepared  
20 documents in your packet. And I would really  
21 appreciate if she would walk us through it and kind of  
22 explain it because I think she has raised some issues,

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1 you know, I think to the point that Jim raised earlier.  
2 This is a process. And how we fix the inputs in the  
3 process is a pretty critical deal. Saying that we are  
4 going to get a technology solution is one thing, but  
5 there are some elements, fundamental changes that have  
6 to occur in our process to make this work in the input.

7 MS. VEDBRAT: I just wanted to touch upon a  
8 couple of, you know, points that were made before I  
9 start. You know, we heard a lot of like, you know,  
10 tactical solutions for, you know, the issues that we  
11 have recently seen, you know, which is all, you know,  
12 very good to be able to solve for those not occurring  
13 again.

14 You know, but just as, you know, James had  
15 mentioned, you know, we need to look at the business  
16 process or in this case, you know, the clearing  
17 framework, which consists of many different business  
18 processes, and then use technology to enable us, you  
19 know, to manage margin or other flows in an efficient  
20 manner.

21 I think, you know, Mike Dawley was asked the  
22 question of what clients are asking for. Maybe I can



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1 help with that. You know, clients are basically asking  
2 for, where is my margin at all times within the  
3 process, what are the risks associated with it, and do  
4 they undergo any type of transformation or  
5 reconciliation. So if, you know, anybody has any  
6 doubt, that is what we are being asked by our clients.  
7 And, in return, you know, we are obviously asking the  
8 same question, you know, from our FCMs and CCPs.

9           The other thing, you know, I just want to  
10 highlight that the CFTC in their rulemaking has made,  
11 you know, some changes that are going to protect margin  
12 for clients, you know, on a going-forward basis, you  
13 know, in a much better way. The gross-gross margin  
14 rule, ELSA, and also changes in rule 1.25 on the  
15 changes to what type of investments can be made, you  
16 know, those are all positive changes from a margin  
17 perspective for clients.

18           But if you just take a step back and we look,  
19 you know, at the past two decades, financial products  
20 have made tremendous advancement in structure. And  
21 these product advancements, coupled with advancement in  
22 technology, the users and the market participants have

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1 also grown. As with most structures and growth in the  
2 use, the introduction of different types of uses  
3 requires adaptation to this change.

4           From a margin perspective, we at BlackRock  
5 have been looking at two main guiding principles.  
6 First is the safety and transparency of our customer  
7 collateral, and the second is margin efficiency. And,  
8 as we step back and take a holistic view on margin  
9 collateral management, within the verticals of futures,  
10 swaps, and cash products, there are some common themes  
11 that begin to emerge. There is a decoupling of  
12 execution risk and counterparty risk. Central clearing  
13 appears to be the method of choice to manage  
14 counterparty risk. And central clearing provides  
15 transparency of position ownership and post-trade  
16 operational efficiency.

17           So highlighted on this chart are some  
18 objectives that we would like to see achieved. And,  
19 with that, we have also highlighted the concerns that  
20 we have. Most importantly on this page are some of the  
21 root causes that are standing in the way causing these  
22 concerns about the safety. And there is an anxiety

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1 attached to that around customer margin and the  
2 soundness of the system that is processing and managing  
3 it.

4           So if you look at the bottom, you know, part  
5 of this page, you will see that neutralization of risk,  
6 ability to net margin, common customer segregated  
7 accounts via the FCMs across CCPs, multiple purpose use  
8 of capital buffer that is supposed to be in place to  
9 protect clients are among a few of our major concerns.

10           So if you move to the next page, this visual  
11 is supposed to demonstrate the amount of variability  
12 that exists today at the multiple levels. So as we are  
13 adapting to a common workflow for better and enhanced  
14 customer risk management and the transparency that  
15 exists across these three verticals also needs to be  
16 addressed. And in certain instances, you know, we would  
17 like to see standardization and simplicity to the  
18 process.

19           It is extremely difficult for clients to  
20 understand and manage the risk exposure given the  
21 number of combinations of risk these structures have.  
22 And in some cases, there is no combination where a

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1 client can control or ring-fence a particular type of  
2 risk that they may want to.

3           For example, if there is an FCM that is  
4 providing clearing services across multiple CCPs and  
5 client A is using or is clearing in CCP1, client B is  
6 clearing in CCP2, and client B is the cause of bringing  
7 down the FCM, client A that has no positions in the  
8 second CCP, their collateral actually may be exposed to  
9 the risk of fulfilling some of the shortfall to the  
10 second CCP. This is a type of risk that, you know, we  
11 are not comfortable, you know, in taking today.

12           And if you look at this chart, you could  
13 almost say that, you know, to some extent, you know,  
14 this is an accident of history because these three  
15 markets --

16           MR. RADHAKRISHAN: Sorry. Are you saying  
17 that money that -- I don't understand. How can money  
18 that is not at a CCP be used at that CCP? That is what  
19 I don't understand.

20           MS. VEDBRAT: Well, the FCMs, you know, they  
21 have --

22           MR. RADHAKRISHAN: FCM fails, right?

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1 MS. VEDBRAT: The FCM fails.

2 MR. RADHAKRISHAN: Okay.

3 MS. VEDBRAT: A conference FCM down.

4 MR. RADHAKRISHAN: And FCM fails?

5 MS. VEDBRAT: Okay? The FCMS have a  
6 customer, you know, segregated pools of collateral.

7 MR. RADHAKRISHAN: Right.

8 MS. VEDBRAT: Those pools of collateral are  
9 for, you know, all CCPs that they provide. They are  
10 not ring- fenced by CCP.

11 MR. RADHAKRISHAN: Correct.

12

13 MS. VEDBRAT: So if there was a customer,  
14 say, just, you know, as an example, like they, you  
15 know, participated only in the CDS market --

16 MR. RADHAKRISHAN: Yes.

17 MS. VEDBRAT: -- and they cleared in one of  
18 the CCPs for that CDS --

19 MR. RADHAKRISHAN: Yes.

20 MS. VEDBRAT: -- and the FCM has a shortfall  
21 to that CCP, --

22 MR. RADHAKRISHAN: Yes.

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1 MS. VEDBRAT: -- the combined seg pool takes  
2 a pro rata hit to that shortfall.

3 MR. RADHAKRISHAN: Okay. That's what you  
4 mean.

5 MS. VEDBRAT: Right? So --

6 MR. RADHAKRISHAN: If there is an --

7 MS. VEDBRAT: -- there is no way that we can  
8 just say, okay, we want to ring-fence ourselves away  
9 from either the product or the CCP.

10 MR. RADHAKRISHAN: But that is immaterial to  
11 where somebody clears. I mean, the issue is that is  
12 embedded in the bankruptcy court.

13 MS. VEDBRAT: And it is embedded in the  
14 framework for clearing.

15 MR. RADHAKRISHAN: True, but the fact, the  
16 reason why your client, client A, takes a pro rata hit  
17 in insolvency is because of the code. So, for example,  
18 even if there is no shortfall at the CCP, the CCP --  
19 let's say, for example, at MF Global, the C&E have over  
20 a billion dollars excess, they had to return that money  
21 to the trustee, and everybody took a pro rata hit. So  
22 you not only had to ring-fence collateral per CCP if

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1 that's your proposal. You have also got to change the  
2 bankruptcy court because as long as there is some money  
3 with the FCM - I think people need to understand it. I  
4 am sure you guys do, but I am not sure all of your  
5 clients understand it. As long as there is some money  
6 at the FCM and there is a shortfall at the FCM,  
7 everybody is going to take a pro rata hit on their  
8 current state.

9 MS. VEDBRAT: Yes. And on the next page, you  
10 know, which we can actually move to because I think as  
11 an industry, if we were starting with a clean slate  
12 today, you know, we would be looking at a lot more  
13 standardization across these markets and also, you  
14 know, across any type of collateral management,  
15 regardless of what type of product we're talking about.

16 So we have actually also mentioned that, you  
17 know, one of the changes, you know, that we would like  
18 to see is, you know, revision in the bankruptcy regime  
19 across these entities to address some of these issues.

20 So if you look at this page, you know, you  
21 will notice that it is a lot more organized or the  
22 chaos from the page before has been simplified to a

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1 large extent. You know, one of the key features that we  
2 feel would help, you know, individual customers and  
3 users is if we have some form of standardization of  
4 account structure, you know, across futures, swaps, and  
5 cash because that will actually allow for like clear  
6 identification of the legal owners of margin and to be  
7 able to keep that link to the positions, you know, that  
8 the margin has, you know, been put in for.

9 Does anyone have any questions on this page?

10 (No response.)

11 MS. VEDBRAT: So, you know, a couple of other  
12 things that, you know, I would like to point out is  
13 that, you know, if we are able to achieve that level of  
14 granularity on ownership of margin, it will help. It  
15 will help clients with the transparency and management,  
16 you know, of where their margin resides. And it will  
17 also help to be able to provide some time in the future  
18 margin efficiency across products. Like, for example,  
19 you know, we may be able to get some sort of margin  
20 relief or margin efficiency between cash positions and,  
21 you know, like derivative positions that we might be  
22 using the clearinghouses clear for.



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1           I think that there was some mention on, you  
2 know, making sure that there is -- you know, as these  
3 rules are implemented, that there is no or there is --  
4 we don't create high barriers to entry for new FCMs.  
5 You know, what we would actually like to see is some  
6 diversification of the categories of FCMs that exist  
7 because, you know, this market is becoming or this  
8 framework is becoming much more important to everybody  
9 and more and more products are moving into it.

10           So, you know, we would suggest that some of  
11 the CCPs look at how could they diversify, you know,  
12 the categories of FCMs that they have. You know, some  
13 of like -- you know, one of the suggestions would be to  
14 create a category for asset managers because that may  
15 actually help to provide at least some solution of  
16 margin protection, which may be a hybrid between what  
17 we have today and, you know, the full seg model that is  
18 being discussed.

19           MR. GREEN: I have just got one question.  
20 When you are talking about the visibility of where the  
21 margin is, you know, particularly given that those  
22 funds are comingled now and there is the pro rata

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1 treatment, are clients really looking to say, "Where  
2 has my T-bill been pledged?" or are they looking to  
3 say, "Where has the FCM deposited its entire pool of  
4 collateral?" or is it both?

5 MS. VEDBRAT: Well, I think over the last 18  
6 months, it has moved from where has the FCM deposited  
7 their pool of collateral to what is actually my  
8 collateral and what type of risk does my collateral  
9 undergo. And the risk is, you know, not only, you  
10 know, from a value perspective but also what could it  
11 be used for.

12 You know, if you look at, you know, margin,  
13 it has many different flavors right now. You have your  
14 initial margin. You have variation margin. You have  
15 excess margin that either an FCM could charge you or,  
16 you know, you house at the FCM. You have excess margin  
17 that you could place at the DCO. And then, you know,  
18 recently there was the introduction of, you know, a new  
19 rule where if you're a non-hedge account, then, you  
20 know, you could be charged ten percent additional  
21 margin if you went below maintenance.

22 So when you start to see all of these

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1 variabilities or, you know, all of these breakdowns in  
2 margin and also the amount of margin that is going to  
3 be required and is going to be required in futures, I  
4 think it's reasonable for clients to actually ask a lot  
5 more detail of, you know, where is their margin; will  
6 it be transformed; you know, what we post, is that  
7 what's going to get posted to the DCO; what could it be  
8 used for; am I in any way, you know, subsidizing, by  
9 leaving excess margin at the DCO, will I be  
10 subsidizing, you know, potentially, you know, in a  
11 default situation other clients; if you leave it at the  
12 FCM, what could the FCM use that for; is there a  
13 difference in that variation margin? There are all of  
14 these questions that are arising from just like, you  
15 know, not really understanding what is happening with  
16 margin at every step of the way.

17 MR. GREEN: So it is very much a visibility  
18 thing?

19 MS. VEDBRAT: It's transparency and  
20 visibility.

21 MR. GREEN: And then presumably for the  
22 client's sake, you are dealing with that is very much a

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1 global situation as well. So they're looking for that,  
2 for those answers across all the global markets?

3 MS. VEDBRAT: Well, we will see the trend on  
4 a global scale. I think that there is a lot more  
5 emphasis, particularly because of, you know, the  
6 mandatory clearing mandate coming in relatively soon  
7 and also the recent events that have taken place with  
8 the two FCMs that, you know, really understanding where  
9 a margin in the U.S. is. That question is being asked.

10 And then it is also linked somewhat to  
11 understanding portability. You know, several of our  
12 big clients have asked us, you know, how is  
13 portability, how does portability happen; have we  
14 tested it, you know, have we tested it, both in futures  
15 and have we tested it in swaps? And, you know, it is  
16 related somewhat to also understanding exactly what is  
17 going on with the margin movements.

18 So in the FCM model, you know, today there is  
19 a requirement that if you are clearing, you know, on  
20 behalf of, you know, other clients and FCMs require  
21 that you have eight percent gap to the buffer, it could  
22 be -- you know, I mean, that gap to the buffer, you

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1 know, obviously, you know, can be used for, you know,  
2 other businesses, too, within a broker-dealer.

3           The two percent is -- as you notice, this is  
4 a proposed state. A two percent buffer is perhaps to  
5 look at a reduced capital buffer if you were an  
6 investment manager clearing on behalf of your  
7 subaccounts and funds, you know, keeping in mind that,  
8 you know, we act in the capacity of a fiduciary and,  
9 you know, you are making investments and you know where  
10 the money is and you are giving instructions for that  
11 money.

12           MR. LEWIS: Do you think that it is possible  
13 from a conflict of interest --

14           MS. VEDBRAT: There -

15           MR. LEWIS: -- guise to do that?

16           MS. VEDBRAT: But there isn't a conflict of  
17 interest.

18           MR. LEWIS: You wouldn't charge them anything  
19 other than the exchange thing?

20           MS. VEDBRAT: It would not be, you know, run  
21 for profitability.

22           MR. LEWIS: Yes.

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1 MS. VEDBRAT: But it would be run for  
2 efficiency.

3 MR. LEWIS: Excellent.

4 MS. VEDBRAT: It is a defense --

5 MR. RADHAKRISHAN: One problem is if you are  
6 an investment manager and you decide to become an FCM,  
7 the money that you take from your subaccounts, there's  
8 no difference in how you take money versus how Mike or  
9 Gerry takes money. So the eight percent is going to  
10 hit you.

11 So are you saying, "Don't hit us with the  
12 eight percent. Hit us with the two percent" because  
13 you are an investment manager? Is that what you're  
14 saying?

15 MS. VEDBRAT: Well, we would want to discuss  
16 that in more detail.

17 MR. RADHAKRISHAN: Okay.

18 MS. VEDBRAT: It is because, you know, you  
19 are actually in charge of the investments. And you  
20 know where the money is coming from, and you know where  
21 the money is going. And it is a contained pool. So,  
22 you know, it has many elements attached to it. And you

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1 are held to - you know, obviously we are held to the  
2 standards of a fiduciary.

3 MR. RADHAKRISHAN: Okay.

4 COMMISSIONER O'MALIA: How has LSOC versus  
5 omnibus seg model changed things? I recognize that  
6 LSOC is not in place until November, but has any of  
7 this changed your opinion about customer protection  
8 fundamentally?

9 MS. VEDBRAT: Well, I mean, LSOC is  
10 definitely a step in the right direction. You know,  
11 and it does provide us with, you know, protection for  
12 initial margin. I think that, you know, as the  
13 implementation of LSOC is taking place, there are some  
14 concerns on how certain pieces of it are being  
15 implemented.

16 You know, we need to have a better  
17 understanding of what happens with the excess margin,  
18 that you post both at the DCO or at the FCM, and what  
19 type of protection do you have and does it in any way  
20 hinder, you know, the speed of portability.

21 And then the other piece that, you know, we  
22 are concerned about is that in a situation of default,

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1 if, you know, you have netting of variation margin and  
2 that netting of variation margin continues post-  
3 default, then essentially what you are doing is, you  
4 know, the first loss still stays with the customers of  
5 that FCM. You know, so that is a big concern. And we  
6 would like to maybe, you know, have some discussions  
7 around it and see if there is a better way of providing  
8 customer protection, you know, for that component of  
9 it, like maybe perhaps the CCP stepping in and allowing  
10 for gross, you know, variation margin to flow through  
11 because the reality is if you have a failed FCM, nobody  
12 is going to be making payments to that FCM until there  
13 is a trustee or, you know, somebody that you know is  
14 going to manage the money.

15 COMMISSIONER O'MALIA: Yes. It gets down to  
16 the point some of the things that Ananda talked about  
17 with the good faith flow of cash.

18 Gerry, can I ask your opinion of FSOC -- I  
19 mean, FSOC. Good Lord. Speaking of transparency, they  
20 could use some. LSOC. Any of what we have talked  
21 about, the technology played, does it matter? Does it  
22 change anything, whether it's LSOC or omnibus?



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1           MR. CORCORAN: Not really, not really.  
2 That's more at the customer level, rather than the kind  
3 of global firm level, the aggregate balances we are  
4 trying to tie out.

5           MS. VEDBRAT: But LSOC would be able to drop  
6 that down to the client's level because you will now  
7 have the book entry, yes, you know, exactly.

8           COMMISSIONER O'MALIA: Anyone else?

9           MR. DeWAAL: The only thing, I think LSOC is  
10 important to recognize. Again, to the extent that a  
11 fraudster is playing around with the fundamental books  
12 and records of the FCM, then it just flows through the  
13 entire system. I mean, again, you know, it doesn't  
14 prevent a fraudster from dealing with that side of the  
15 ledger.

16           MS. VEDBRAT: I think, you know, one piece  
17 that could be useful is because now we are going to  
18 have, through LSOC, you are going to have, you know,  
19 recordkeeping or, you know, book entry at the  
20 individual customer account level, the CCPs are also  
21 going to be calculating, you know, daily margin. So,  
22 you know, if that information that the CCPs calculate

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1 is made available to clients, then there can just be,  
2 you know, with the client, you can have a  
3 reconciliation, you know, because right now clients  
4 have, you know, one flow, you know, one pipe of  
5 information flow. And that's through their FCM. That  
6 would be one natural way of, you know, reconciling  
7 margin. We reconcile everything on a daily basis that  
8 comes from FCMs performing, giving instructions to the  
9 custodians to make payments.

10 So this piece of it I think would be a very  
11 easy ask. And it may prevent, you know, what Gary  
12 mentioned from an FCM perspective.

13 MR. VICE: I agree with all of that, but, I  
14 mean, I think it is important to remember that the  
15 funds that the CCP has vis-LSOC are the I think  
16 collateral that is acceptable by the CCP, is not  
17 necessarily; in fact, often the case is it is not, the  
18 actual collateral that the customer may have posted  
19 with the FCM.

20 So still that is an important service that  
21 the FCM provides, that collateral transformation. And  
22 sometimes we kind of forget about that. And that is

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1 what makes it so complicated. Everything is not a  
2 simple passthrough.

3           The comment I wanted to make though, was I  
4 think there are very good trends on cleaning up all of  
5 this diversity in your chart that are already going on.  
6 I mean, speaking for ICE, we operate four  
7 clearinghouses. Some of them we bought. Some of them  
8 we built. In terms of discretionary policies that we  
9 have, we have spent, you know, the last year -- and it  
10 is still ongoing -- looking at all of the different  
11 rules and policies that we set, where are they  
12 different, why are they different, let's decide which  
13 is the best practice and standardize all of that.

14           I also think that a number of foreign  
15 clearinghouses, certainly ICE Clear Europe, I think LCH  
16 - - I don't know who else -- are registering as U.S.  
17 DCOs. And I think this goes a long way toward both  
18 standardizing, whether it is gross margin or net margin  
19 and a lot of other variables. It also means U.S. FCMs  
20 are largely joining those clearinghouses. So a lot of  
21 the 30.7 problem goes away assuming regulatory approval  
22 of comingling requests and such, which presumably is

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1 straightforward.

2           So I think a lot of this gets a lot better,  
3 not only in terms of removing some of the noise  
4 variability of U.S. clearinghouse but also capturing a  
5 lot of "foreign futures" or "foreign swaps," if that's  
6 the right term, and basically having them behave under,  
7 say, U.S.

8           rules and have the same customers, U.S.  
9 customers having the same, rights and privileges as  
10 they would as if that were a U.S. future.

11           COMMISSIONER O'MALIA: Anyone else? I don't  
12 want to keep anybody here longer than we have to, but  
13 any final thoughts?

14           MR. VICE: Scott?

15           COMMISSIONER O'MALIA: Yes, Chuck?

16           MR. VICE: Sorry. One final thought, back on  
17 the more mundane discussion of being pushed and end of  
18 day and all of that, I thought Gerry made a very  
19 important comment about the holistic approach. And,  
20 you know, with white collar crime, I doubt much white  
21 collar crime is going to occur if the criminal knows  
22 there is a 100 percent chance he is going to be exposed

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1 within 24 hours. And so I think we shouldn't  
2 underestimate that there is a tendency to want to build  
3 a bulletproof prevention system.

4           And I think we need to -- you know, a lot of  
5 that will go on and needs to go on. It will never be  
6 100 percent bulletproof. At the end of the day, you  
7 will know that, the knowledge that you will be caught  
8 at the end of the day true-up at noon tomorrow, without  
9 question, I think. And the fact is that on one of the  
10 FIA's recommendations is around the CFO write-offs on  
11 withdrawals of residual interest from these accounts.

12           I watched the MF Global testimony. And there  
13 was I think a U.S. CFO and a European CFO. And neither  
14 one of them knew how money was withdrawn apparently.  
15 And so I think the fact that, you know, if you take  
16 that concept and maybe you elaborate on it a little  
17 bit, when the withdrawal is in excess of a percent of  
18 excess or a percent of a dollar amount, then more  
19 approvals are required on it.

20           I think I could also have my bank send me an  
21 email when my wife withdraws \$500 out of an ATM. They  
22 probably have that service. So I don't know why. You

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1 know, back on Ananda's point, when someone is trying to  
2 pull the money out, that is the point we should focus  
3 on and as part of the confirmation system and  
4 collecting the electronic snapshot each day, perhaps  
5 intraday, rather than focusing on all the real-time  
6 noise, which I 100 percent agree any time in the near  
7 term that is not where we should focus our effort, but  
8 we can focus the effort on the intraday withdrawals of  
9 any magnitude and making sure a lot of people are aware  
10 of that and are saying, "Hey, what is this? And why is  
11 it going on?"

12 MR. DURKIN: Just speaking for the ones that  
13 are doing those reviews, those are the steps that are  
14 being employed today and will continue to be refined  
15 going forward. So people should not leave this room  
16 not thinking that substantial progress has been made.  
17 It may not be the panacea of where we ultimately need  
18 to evolve to, but we are far better ahead today than we  
19 were six months ago, basis what we learned from these  
20 situations. And we are going to continue moving it in  
21 the right direction.

22 MR. HURST: Back on the mundane topic of

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1 technology, one point just to be made quickly, Cliff is  
2 being modest. There is tremendous capability in terms  
3 of technology for customer protection that is resident  
4 inside of State Street, inside of Northern Trust,  
5 inside of BNY Mellon. And I would encourage this group  
6 to tap that, maybe even lean on Cliff to pull a few of  
7 those terms together as a group to show you what they  
8 can do today. That is available, and I think they  
9 would be anxious to put it to good use.

10 COMMISSIONER O'MALIA: John?

11 MR. LOTHIAN: Just one final thought. One of  
12 the things that Dodd-Frank had was a whistleblower law.  
13 I have a neighbor in Elmhurst who used to be in  
14 accounting at Peregrine. And in 1995, he told Russ,  
15 Jr.

16 and Russ, Sr.'s wife and the current CFO at  
17 the time that Russ having access to the statements  
18 alone was a control problem. So the problem was  
19 identified back in 1995, but there wasn't a mechanism  
20 in order to really encourage that to come out to a  
21 broader level.

22 If you go back to the Lehman case, the

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1 Valukas report, to raise your hand and to say that  
2 there was some kind of fraud within Lehman was to get  
3 fired and to be excommunicated from the industry.  
4 Okay? Part of any, you know, detection of fraud has to  
5 be we have to be able to protect or even reward the  
6 people that are willing to stand up and say, "Hey, here  
7 is something that is wrong."

8                   And, quite frankly, this isn't an exact  
9 parallel, but we have a situation in front of us with  
10 the MF Global case where you have the Assistant  
11 Treasurer of MF Global who says, "Hey, I'll be glad to  
12 tell you what is going on, but I want immunity first."  
13 Okay? And there is a situation there where this is  
14 caught up in a tremendous amount of politics that is  
15 even bigger than all of us, it seems. But, yet, we are  
16 not able to get that done. And that would, you know,  
17 either moving forward or doing something there, would  
18 give us at least some closure in the MF Global  
19 situation. So there is this negative connotation.

20                   I have had a lot of people that have emailed  
21 me or called me over the last couple of weeks about the  
22 ethics situation within the industry. And raising your



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1 hand doesn't get you job, you know, promotions. It  
2 gets you excommunicated. So that is one of the things  
3 that I think we need to address, too, from a holistic  
4 standpoint, is protecting the people who are willing to  
5 raise their hands.

6 COMMISSIONER O'MALIA: Too many  
7 whistleblowers out there. Thanks to Barclays, that  
8 fund is fully capitalized.

9 Anybody, any final thoughts?

10 (No response.)

11 COMMISSIONER O'MALIA: Well, let me thank  
12 everyone for coming. Let me first thank our staff,  
13 thank the technical people that put this on, Laura and  
14 Andy and Carl and Michael, thank them very much on my  
15 staff for their assistance to help organize this in a  
16 short time frame. I thank Ananda and Gary Barnett and  
17 all their staff for helping us kind of wade through  
18 this.

19 These are important reforms. Technology is  
20 one element of it. NFA has put forward their rule 16  
21 changes that are going to bring transparency and some  
22 other things, but I think technology is a very critical

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1 element to Chuck's point. If you know you can't get  
2 away with it long, you are very unlikely to pursue it.  
3           So we are going to continue to work on this.  
4 In fact, I am going to ask at our next Technology  
5 Advisory Committee -- we're planning for October 30th  
6 in Chicago. And we are largely going to convene that  
7 meeting to receive recommendations from the High  
8 Frequency Trading Subcommittee. I have decided that we  
9 are going to also put this back on the agenda, and we  
10 are going to get an update on where we are because, to  
11 everyone's point about what a challenge it is to put  
12 this together, it is important to show progress and  
13 figure out where we are. So that is in a few months,  
14 and we are going to want an update on where we are in  
15 implementing the reforms that we have all talked about  
16 and agreed to on a technology front and walk through  
17 that to see where we are at. Maybe we can get an update  
18 on our rule process and how we are working through that  
19 in developing our rules further. And then we can  
20 identify any gap analysis that we need to do to figure  
21 out what is left and what real timetables that we can  
22 come up with. So October 30th we will meet again in

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1 Chicago. And we will talk about HFTs and technology  
2 solutions for the FCM space.

3 I am mindful that you can't spell bankruptcy  
4 without TAC. We are not going to tackle that one.  
5 That is a much bigger question, but it is a common  
6 theme I have heard today about customer protection and  
7 some things like that. So I know that is not going  
8 away. And we will continue to look at that. I have  
9 made recommendations that we need to think, we need to  
10 put customer protection and bankruptcy. You know, the  
11 action in court has got to match the rhetoric. We keep  
12 talking about making customer money the top priority.  
13 Yet, month after month as we wait for a decision on the  
14 disposition of customer funds, we find that it is not  
15 quite at the same level we aspire it to be.

16 So, again, let me thank all the TAC members,  
17 all of the panelists here that have rearranged their  
18 schedule under short notice during the summer, probably  
19 breaking vacations to be here today. So I thank you  
20 very much for that. And if you have any thoughts,  
21 concerns, other comments, you want presentations added,  
22 please let us know. I think our record is open for a

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1 little bit, and we will be happy to include those  
2 things. All of the presentations I believe will be on  
3 the website. So look for it there, for the public  
4 comment as well.

5 So thank you very much, all, for coming.

6 (Whereupon, at 3:43 p.m., the foregoing  
7 matter was concluded.)

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