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COMMODITY FUTURES TRADING COMMISSION

MARKET RISK ADVISORY COMMITTEE MEETING

Washington, D.C.

Monday, November 2, 2015

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P R O C E E D I N G S

(10:00 a.m.)

MS. WALKER: Good morning. This meeting of the Market Risk Advisory Committee is now open. Commissioner Bowen will welcome.

COMMISSIONER BOWEN: Good morning. And thank you everyone for being here today. I do want to encourage you to have donuts and coffee in the back.

Before we begin our panel presentations, I invite Chairman Massad to give his remarks.

CHAIRMAN MASSAD: I will be very brief. First of all, I just want to note that Commissioner Giancarlo had planned to be here today but could not be. Unfortunately, his father passed away late last week, so our thoughts and sympathies are with him and his family.

Secondly, just on today's topic, all I want to say is the issue of CCP resiliency is critical. I've said this since the beginning of my term. It's very important that we've mandated central clearing of swaps, but I've also said that with that comes the fact that we must focus on CCP strengths and resiliency. We've made CCPs more critical in the financial system.

So this meeting is extremely helpful and important in that regard. We obviously have a lot of activity going on in this area in many ways, and so I just applaud Commissioner Bowen for having the MRAC focus on this, and I look forward to the discussion today.

COMMISSIONER BOWEN: Thank you, Chairman Massad. I also extend my deepest sympathy to Commissioner Giancarlo and his family on the loss of his father. Are CCPs prepared for what would happen if a significant clearing member defaulted? That was one of the questions we asked in our inaugural April 2nd meeting of the Market Risk Advisory Committee. At that meeting, three of our CCPs -- CME LCH, and ICE -- made presentations about how they are preparing for such a default. These presentations prompted a fruitful discussion, and as usual, our MRAC members brought great ideas to the table. Following that meeting, we established a CCP Risk Management Subcommittee to delve further into the issues that were raised. The Subcommittee is composed of a diverse group of market participants, including clearinghouses, clearing members, buy side, end-users, and academics. And it is ably led by Tom Kloet of Elmhurst College and Susan O'Flynn of Morgan Stanley.

The Subcommittee was tasked with answering two questions that came out of the April 2nd meeting. If we had a significant clearing member default, could the efforts outlined in the CCP presentations be even more reflective of actual market conditions? Susan O'Flynn has led the Subcommittee's discussions to respond to that question, and we will hear their recommendations today for the consideration for the Full Committee.

The second question is whether we could do more to further coordinate the efforts of CCPs to better prepare for it. Tom Kloet will lead the Subcommittee's discussions to respond to the question, and as a follow-up to that question. And as a follow-up to our June 2nd meeting, they are on track to make recommendations early next year.

As I said at my first MRAC meeting, though I believe it is unlikely that a significant cleared member, one whose default could pose a systemic risk would actually default, it behooves us to do everything in our power to best prepare for it given the implications for our economy.

As vice chair and chair of SIPC, I saw firsthand how devastating the collapse of influential marketplace participants can be. I also personally know individuals whose careers and lives have been permanently altered by the 2008 crisis. We regulators owe it to investors and consumers to do everything we can to prevent another crash, even more so, while the global economy is still digging out from the damage of the 2008 crisis.

As I noted in my inaugural speech, we cannot be complacent. Just because we've made progress in trying to fix the problems that caused the last crisis, that doesn't mean we are yet prepared to address future potential threats. Thus, the importance of effective, robust risk management of our CCPs cannot be overstated. I am therefore eager to hear the viewpoints of the Subcommittee today and the other MRAC members, and I thank all of the Subcommittee members for being here today to share your views. I especially want to thank Susan O'Flynn for her leadership of these efforts, and both Susan and Gerald Beeson for their tireless efforts in drafting.

Due to a scheduling conflict today, I will need to scoot out before we close today's meeting, so I also thank Tom, who will provide a recap after the third panel before we close the meeting.

It is important to me that the MRAC not only be a forum to discuss important issues, but a Committee that gets things done. I am confident that these recommendations will be the first in a line of consequential work product from this

Committee. I also would hope that interested members of the public who are watching this meeting would also submit their views.

I will now turn it over to Ms. Walker, who will introduce our first moderator and panel.

MS. WALKER: Ms. Susan O'Flynn, who is managing director and co-head of the Markets and Securities -- I'm so sorry -- managing director and global head of CCP Strategy Governance Optimization at Morgan Stanley will be leading our first panel.

MS. O'FLYNN: Okay, thank you very much, Commissioner Bowen and Petal, for your opening remarks and comments.

Just a few logistics for everyone. When you want to speak, please press the button on the microphone. To the extent you want to make a comment, please put your name card on its side so we can go to you following my presentation of the recommendations.

So to give everyone a bit of background, obviously, there have been several months of calls and coordination with all the participants in this room around what recommendations we wanted to make today. The first panel is going to address in particular interdependencies between CCPs and key intermediaries in markets. The issue description is set out in the recommendations as set out today for everyone here, so I won't read through those. Okay, I'll speak up. But, you know, I'd like to summarize the recommendations that were made by this group to the CFTC.

Around interdependencies. The first one, suggestion of incorporation of -- incorporating in default drills the idea that one of the defaulting members is an institution who provides one of the larger liquidity obligations.

Recommendation two. When looking at liquidity stress testing, move from potentially a cover one to a cover two analysis. Look at what the liquidity situation would be from a CCP perspective if two large clearing members defaulted, not just one.

And three, disclosure of the diverse,

you know, disclosure of liquidity sources that the CCP has, obviously, in a manner which preserves confidentiality to a broader universe of a broader audience, you know, including regulators, clearing members, to be able to demonstrate the diversity of those liquidity sources to give greater clarity.

Now, they were the three agreed recommendations with the group, but before we go into a little more detail, I'd like to open the floor to our CCP colleagues here to kind of give your thoughts on that. Obviously, before we go into this, there's been a number of initiatives. Obviously, the PFMIs around quantitative disclosures, you know, go live Jan 1 in 2016, which will address some of these, you know, some of these requests for increased disclosures, but there is potentially the gap that there will be more transparency required by the market participants I've just mentioned.

So who would like to go first from a CCP perspective?

MR. CUTINHO: Hi, this is Sunil. I'm from the CME. In fact, as far as the recommendations are concerned, they are very good recommendations, and some of them are actually -- in fact, most of them are addressed in the CFTC rules as well. When we -- there are a few things for us to keep in mind, so let's look at this topic of interdependence. I'm glad that the focus is on liquidity facilities. It's important that when we look at our liquidity facilities that we also take into account the potential failure of a member providing those facilities. The same goes for the repos.

But when we talk of settlement banks and custodians, we've got to take a step back. There are a few things that are happening there. When we look at settlement banks, I believe, but I'm not sure, that the prudential regulators for banks are actually encouraging banks to avoid dependence on other SIFIs to settle with FMIs. So there is definitely a trend where we will see a lot of clearing members which are affiliated with banks, especially systematically important banks who will actually settle with us directly.

When you look at settlement banks, the way to think of settlement banks is they are an operational mechanism to actually move funds to an FMI. You know, it is impractical to expect every clearing member to have multiple settlement bank relationships. No settlement bank will support that. So I think the better solution there is to actually provide facilities for clearing members to actually pay the CCP directly at alternate banking centers if their primary settlement bank has failed. So that's a much better approach.

Now, when we talk of custodians, the way to think of custodians is that, you know, they're not just providing services to a CCP. In fact, the custodians that CCP use are widely used by market participants for non-CCP activity. When it comes to custodians and settlement banks, it's important for not just CCPs but actually even our primary regulators -- the CFTC, the SEC, and FINRA -- to have a good insight into how such institutions will perform under resolution, especially when the FDIC steps in. And so that is the clarity that I think we are missing, because when we look at these institutions and when we look at the actions of a resolution authority at a bank, we need to make -- we need to understand what actions will be taken, vis-à-vis the services provided not only to FMIs but to market participants. I think, we, as CCPS, with Tom's help, we actually wanted to have a session with the FDIC and get into not only these details but others.

So as far as custodian banks, the market actually has reacted post-global financial crisis, and if you look at market participants these days, a large part of -- a large percentage of market participants would actually not use the same custodian services of a clearing member affiliate, but they would use a third party for their activities or the CCP. So it's important for CCPs to support a broad array of custodians, and I would request from the CFTC's perspective to also look at CSDs because today CSDs -- U.S.-based CCPs cannot use, you know, security depositories in Europe, or based in Europe, or based outside the U.S. So it's important for the CFTC to look at it. I know the CFTC is looking at it, but those are all alternatives. So as you give market participants more alternatives, it's better for the industry.

I'll yield my time now.

MR. MCLAUGHLIN: Yeah, this is Dennis McLaughlin from LCH.

So I do support the recommendations that have been laid out in the paper. I think they go some way, but probably not all the way, but some way towards addressing some of the real issues that we face. A lot of the problems that CCP actually faces comes down to liquidity in a number of ways, and we do partly address these in the recommendations.

The first way is that if there was a stress event in the market, then by virtue of the way the VM, the variation margin calls work, the

CCP would find itself drowning in cash. And under current rules, it is very, very difficult to find a home for that cash, and these tend to be overnight rules. We have to, especially client, that we would have to be able to deposit them within the rules. So it argues for some kind of mechanism to help CCPs to have a deposit account somewhere that's not with commercial banks. So this could be like a central bank account or something like that. It's not a credit risk because the CCP is depositing cash so there's no credit involved.

This question of liquidity also arises in the portability question because especially for clients, if there is a member default and that member has a lot of clients, then, of course, we can operationally work out how to port the clients but there's no guarantee that there would be an existing nondefaulted member who would actually take those clients in the stress event. And this is linked to many problems such as the declining capacity for FCMs that are available, particularly caused by the repo market shrinking balance sheets that we are seeing in the markets today as a result of the supplementary liquidity ratio, et cetera.

So the third point that I'd like to make is that this liquidity thing keeps coming back in many, many different ways, and one of the ways is if you look at the way the CCP has to -- when a default event happens, the CCP has a lot of margin. Its noncash margin that it has to instantly turn into cash, and this is linked to the problem that is addressed in this paper of the other financial institutions that are not banks, that are not members, but things like Sunil was talking about, custodians, settlement platforms, et cetera. If there's a problem in one of those, then, of course, from a financial resource perspective, the CCP has enough financial resources but there is a liquidity problem because those financial resources cannot be transformed into cash at the drop of a hat. So some other kind of mechanism is required because obviously the CCP can't -- it's a third party. It cannot really do that much to affect this transform, so particularly if it's a market infrastructure player, some other mechanism to free up the cash, free up the bonds to turn into cash is required. So these recommendations all go towards the liquidity problem, and obviously there's more that can be done but these are certainly your first start.

The final thing I'd like to point out is liquidity also affects the investment activities of the CCP because the CCP, by virtue of the fact that it has so much margins from clients that it needs to manage, must be able to put those margins somewhere. And it does so right now primarily in the repo market because under various regulations it's restricted as to where it can place the cash. And so therefore, the availability of capacity in the repo market plays a key role in the CCP's day-to-day activities. And this capacity is shrinking. So again, the ability of the CCP to access liquidity is what's really the driving force, I think, behind a lot of these recommendations.

I'll leave it there. Thank you.

MR. CUTINHO: I just -- wow, now it is working. Okay. I just wanted to add a few things to what Dennis was talking about.

In terms of CFTC rules, I think there is a rule, 39.33, that really talk about noncash collateral, so it has to -- if a CCP decides to take noncash collateral, it has to have a commented or prearranged, reliable facility. And two things there. One is a CCP like ours, we have a facility and then it's also transparent. So it's a diverse set of sources that are 27 members who participate in this commitment today, and they're not all clearing members. They're not all affiliates of clearing members, but it's -- the important thing there is you cannot expect a liquidity facility or a large liquidity facility to be provided independent of banks. Banks are an important part of the financial infrastructure, so they are in the business of providing liquidity.

So, of course, CCPs are looking at a diverse set of nonbank sources, but even if you look at nonbank sources, they are going to use a bank in some capacity. So I think it's important to keep that in mind.

The other issues that Dennis is talking about are issues that are not specific to the U.S. but are in Europe where 95 percent of your cash, which is taken as margin, has to be converted to collateral through a repo system. We agree with Dennis that in times of stress, you will see actually a lot more cash come in. It just exacerbates the problem that a CCP would have in such a jurisdiction, especially if the repo market is also having issues.

MS. O'FLYNN: Can I just ask a question? You know, thank you very much for your input but I think, you know, it's back to Dennis's second point, and Sunil, I think you've just raised it there. How from a CCP perspective have you kind of changed your, I suppose, liquidity and diversification in recognition of the fact that the repo markets are shrinking given the (inaudible) constraints that a lot of core banks have and the accessibility of getting either cash or securities in good times and in stress times?

MR. CUTINHO: I'll answer. I think Kevin wants to answer as well. So I'll kick it off.

The way we look at it, we look for a diverse set of sources. There are some nonbank, you know, investors who are interested in this market as well, but the market hasn't developed yet. It is still in the process of it. I know our colleagues at the OCC, they have managed to do that. But the price is still higher. So to the extent that the prices are not as competitive as banks offer, you'll have a lot more banks in the facility versus investors. But that natural balancing act will take place as time passes on because some of the rules -- in fact, for the liquidity facility, the capital rules that impact -- directly impact banking institutions is LCR, and to the extent that gets phased in, you will see a lot more balance in the market.

MR. MCCLEAR: Good morning. Before I get into the specific question I'd just like to make a few introductory remarks on behalf of myself, Kevin McClear. I'm ICE's corporate risk officer.

First of all, I wanted to thank the Commission and the panelists and the marketplace for including ICE. We own and operate seven clearinghouses, so we're very familiar with these issues. I'll echo both what Sunil and Dennis said. These issues, these recommendations, they're not new to us. As Sunil pointed out, many of them fall under our regulatory regime, so we're already addressing them. Many of them we're working on, and any outstanding ones we look forward to working with the Committee and the marketplace, the users to resolve the issues.

The questions around interdependencies and interconnectedness are involved. As pointed out in the recommendations, they touch upon liquidity facilities, repo lines, macro hedging strategies, settlement services, custodian services, but as we've noted early on, they all eventually come to liquidity, the question of liquidity. And to answer your specific question, what are the clearinghouses doing? What is ICE doing? Like Sunil, we're starting to explore, because the repo lines, they are tight. We're finding it hard to find the repo counterparties, the repo transactions are expensive, and quite frankly, we don't know if they're reliable. They're commercial agreements, and the entities that we enter into these repo transactions with will be facing stress like us during these unique market conditions and they'll have their own liquidity needs. We hope they honor their commercial relationships or obligations, but we don't know for sure. So we are exploring nonbank facilities like OCC did. There's a lot of pension money out there, but those are in the exploratory stages.

The best and safest place to place this cash we're talking about would be with the central bank. Now, at ICE Clear Credit, we're SIDCO. We're systemically important, and we have the ability under Title XIII -- had the ability to apply for an account. We have an account and frankly, that's where we put most of our cash. That's the safest, most liquid source for our cash. At ICE Clear Credit I should say, we're fundamentally liquid to begin with. Forty-five percent of our margin and guarantee fund requirement has to be in cash. U.S. dollar if it's a U.S. Dollar contract, or euros if it's a euro contract. Twenty percent can be in U.S. dollar cash and U.S. treasuries, and then 35 percent can be in U.S. dollar cash, U.S. treasuries, or G7 currency. So we're highly liquid to begin with, but we do hold a lot of treasuries, and we've been saying these repo facilities are hard to obtain, maybe not reliable. We think the best source to get treasury liquidity would be the Fed. We don't want to borrow money but we think we should have access to the discount window to give the Fed our treasuries at a haircutted rate, say 105 percent U.S. Treasuries for cash, only in exigent circumstances. Only during times of stress, not as business as usual.

I'll just tick through a couple of the other points that Susan raised, too, because I think it's important for everybody to understand that the clearinghouses are dealing with these issues. For instance, with the interconnectedness and interdependencies of those institutions I mentioned, we've started to incorporate into our default test say a settlement bank failing at the same time a big clearing member fails. I think that's very important. Cover two you raised at ICE pursuant to our liquidity framework. We do cover two. We're looking at cover two.

I think I've taken through -- oh, transparency. We are -- clearinghouses are highly transparent and I think maybe we need to do a better job of communicating with the marketplace how transparent we are. But if you look at our rules, look at our disclosure framework, we're highly, highly transparent with our regulators.

We're very transparent with our clearing members. And as Susan pointed out, starting January 1, 2016, the CPMI IOSCO Public Quantitative Disclosure Requirements will commence. And you should go to CPMI IOSCO. You should look at those disclosure requirements. They are very comprehensive. They'll be, I think, almost too much information for the marketplace to digest, but it's all going to be there.

With respect to disclosure about some of these interdependent relationships to a broader set beyond the regulators, beyond our clearing members to the marketplaces generally, we do have to be careful. We do have, as I say, commercial relationships. We do have confidentiality obligations, so we just need to be cautious about it.

Thank you.

MS. O'FLYNN: Okay, Clifford?

MR. LEWIS: Thank you. I should try to fake a German accent so I sound more plausible as a spokesman for my friends in Frankfurt.

But just three points. First, and most importantly, we, as my friends here are saying, we are supportive of the recommendations. Great job. And it's provided a useful guide to check that what we're doing on our own is appropriate, that we're following the best practice advice coming from a Committee like this.

Two things in particular I want to mention, however, that are a little bit different about Eurex Clearinghouse, not necessarily as better but just to capture some of the regulatory and historical differences between our fundamentals and the fundamentals of American clearinghouses. First, much more emphasis on electronic trading drove a much different approach towards the infrastructure associated with the clearinghouse, and among other things, for example, that basically meant that the clearinghouse was designed to support full segregation at the customer level. From a technology or administrative perspective, that sort of technology capability frankly is probably essential to realistically be able to address transferring thousands of subaccounts in real-time. It's hard to see how you could do that unless you built the system for that purpose at the beginning, and I know that there are big investments being made by my colleagues here, and I'm not suggesting that they don't have that capability. I'm just suggesting that some of that plumbing is very important at the clearinghouse.

The second point I'd mention, which is perhaps even more important, two elements to which, Eurex Clearing is a bank. That's been a point of great controversy in the U.S. clearinghouses back to my day back at the late lamented Board of Trade Clearing Corporation that almost applied for a banking license about 25 years ago. Being a bank has a number of factors that inherently address this. The German structure is a little bit different because actually, we are a systemically important bank. A lot of our pays and collect activity are done at the gyro accounts at the Bundesbank, which obviously takes out a layer of risk in all of this. And I'm not suggesting that the banking license approach is the right approach; there are issues with that. But there's an interesting corollary of that which is worth noting in passing, which is when I go to the Supervisory Board in Frankfurt, I'm sitting next to a representative at the Board meeting of the Bundesbank in BaFin, the equivalent of CFTC. They attend the Supervisory Board meetings. Bundesbank in particular is intimately involved in the details of these liquidity management processes, and indeed, that's one of the key differences of having a banking license and access to the Bundesbank. And I know the other side of this as Kevin was alluding to of having access to the discount facilities of the Fed is important. I'm just also pointing out that almost -- the work that the Committee has done in terms of bringing different parties together, there's also a governance issue in this, too, that in fact, getting close to the central monetary authority, if ultimately that's going to become an important part of the process in a highly stressed environment, is very important to start doing. What Sunil said about getting together with FDIC, for example, so that actually there is some convergence between the resolution, the philosophy of resolving a large bank is not completely inconsistent at FDIC versus our world. But as I say, it is actually -- my observation is it is a wholesome thing to have the kind of relationship that has sprung from being a bank, from being a systemically important bank and having the kind of relationship that we have with the Bundesbank.

MS. O'FLYNN: Any views from the sell side or buy side?

MR. KLOET: I guess first I'd like to congratulate you, Susan, and the people that worked on this to put together these recommendations, and I'm very happy to hear the support from the CCPs with respect to these recommendations.

I'm especially encouraged and would

support the idea of allowing, under certain conditions, the systemically important CCPs to have access to the Fed. I think that's -- I think that's really important, and being able to do that could help provide liquidity.

There was one thing in the recommendations that I just wanted to understand a little bit better because I'm not suggesting I don't agree with it but I just want to understand it a little bit better. When it came to the third element about -- that CCPs should demonstrate that they have access to sufficiently diverse liquidity resources, it talks then further about disclosure and it suggests that the disclosure of the information, which presumably is where they would be getting these resources from, should be limited to a defined universe. And I guess I'd like to explore, you know, why that should be the case, if not at least once a year we shouldn't get some information from where the CCPs are potentially relying on those liquidity resources. If it's a matter of competitive dynamics -- maybe that's what it's all about -- I certainly don't think we should have in the public domain the pricing on any of that. But with respect to what the liquidity resources are, and in general, what category of other market participants might be giving liquidity resources, I just wonder about whether or not it's in the public interest that that be disclosed, at least on a once-a-year basis. And was curious what the thoughts were behind not disclosing that.

MR. MCCLEAR: I can add a little color to that. One of the issues is a technical legal issue, so when we enter into these repo transactions with the big banks, there's a confidentiality provision that says that the agreement is effectively confidential, private. I think the solution will be -- and you'll find some of this in the CPMI IOSCO public quantitative disclosures, is to disclose and, again, regulators see this or clearing members see this, say the percentages, how much of our liquidity is dependent upon repo transactions, how much cash do we hold, how much treasuries do we hold. I think if we reported broadly like that it should satisfy the need, as opposed to identifying each and every specific individual repo counterparty by name.

MR. KLOET: To be clear, I guess my suggestion wouldn't be -- and I don't want to get into the micro part of this -- but wouldn't be to identify specific counterparties but rather, you know, we rely on banks to provide this much of our overall liquidity, nonbank and financial institutions provide this much of it, and the various assets. I would group it but I would think it would be in the public interests of the market participants to be able to know what the liquidity -- what the potential liquidity resources of the CCPS are.

MR. CUTINHO: Yeah, you have a fair point. In fact, our facility is public. It's actually on our website. So there's nothing wrong in putting the sources.

MS. O'FLYNN: I think maybe, you know, is the ideal state -- and maybe this is where the

CFTC can play a role is understanding the mix of committed versus uncommitted and a sector concentration with say large clearing members. You know, obviously preserving confidentiality is critical, but I think, you know, it's kind of, I suppose, framing the liquidity playbook that you each have and, you know, kind of, I suppose, ultimately being able to kind of give greater clarity around exposure you have to any particular sector of client base, be it a bank, nonbank, or potentially even a customer. That's just an observation.

MR. KLOET: Susan?

MS. WALTERS: Kristen.

MR. KLOET: Oh, I'm sorry. Kristen?

MS. WALTERS: Thank you. Thanks, Susan, for organizing and doing so much work on the Committee. And thanks to Commissioner Bowen and Petal as well. We very much appreciated participating.

You know, these issues around liquidity are very real. I mean, there indeed has been a secular shift in liquidity post-financial crisis, and many of the regulations that were implemented post-financial crisis that have impacted dealers' capital, liquidity, and so on and so forth, they were intended. They were necessary, but they do have a very meaningful impacts in this space. And so there is less liquidity. There are fewer participants. There has been tremendous compression in the number of FCMs clearing members. The CCPs are small in number, and in some respects, you know, small monopolies, which I think makes transparency very, very important.

Kevin, you were speaking about transparency, and I know there has been a concerted effort by everyone kind of in this room over the last year to make sure there is sufficient liquidity and transparency. From a buy side perspective -- and we'll talk about this a bit more in our third session -- I just want to highlight that, you know, so again, as an asset manager, we're a fiduciary on behalf of clients. We don't have assets. We don't have transactions that are physically being cleared. We don't have skin in the game ourselves. However, we do have the fiduciary responsibility to make sure that we understand the counterparty risks that our clients have when they're clearing transactions on exchanges. In the current environment, we actually -- our counterparty credit risk team that independently vets, you know, 800 counterparties that we transact on behalf of clients against every year, prefinancial crisis we had the ability to do proper due diligence for every counterparty with whom our clients transacted. So if it was in the traditional bilateral OTC derivatives markets, that was with banks, and we had the ability and we did do very extensive and robust and comprehensive due diligence to understand the financial condition of the counterparties, as well as, you know, the ISDA agreements themselves, laid out all relevant issues around margin, potential to exposure, what happened in the instance of insolvency, and so on and so forth.

And so there was risk in those

transactions and that market structure, and we believe that the risk in the current market structure, the cleared approach, is actually theoretically much better. However, we still struggle because, you know, as a fiduciary, we are currently not able to do the type of due diligence that we need to do on CCPs. So we do not have access currently to the loss-absorbing resources of the CCP. We do not know how stress tests are conducted. We don't know the amount of potential losses that could occur in the instance of a single or multiple clearing member default, and we simply don't know in the instance of default whether or not our clients will be made whole or the market itself will be made whole. And I think that we need to think about these issues very, very seriously and come up with solutions. So when regulated entities like banks, you know, it's a bit of an open kimono in today's market. I mean, every single -- I mean, the banks hold capital, they do stress tests that are overseen by regulators. They are held to all kinds of very, you know, to be honest, constraining capital and liquidity measures. And I think that's for good reason. And in this environment where we've shifted to central clearing, I think that we really have to ask our CCP counterparts to be held to the same standards, to have appropriate levels of their own capital against losses, and to fully disclose every single detailed component of loss absorbing calculations, margin methodologies, and stress tests. And I think it should be done in a way that's consistent and can be measured across CCPs. I know that we're trying to move in this direction, that everyone is on the same page, but I just want to highlight that today, you know, I speak for BlackRock, but I think, you know, Angela will speak later, and others who we worked with on this SIFMA -- AMG kind of drafted the buy side's views of this space -- is that it's something that the buy side sector is very, very concerned about and we view it as a real issue that needs to be addressed and solved.

MS. O'FLYNN: Andrew?

MR. GRAY: I just wanted to, along with my CCP colleagues, again thank the Commission for including DTCC in these discussions.

On the topic of best practices and default management, as has been stated in the recommendations, a number of the recommendations actually don't necessarily apply to security CCPs because we operate a bit differently from derivative CCPs. But nonetheless, there are some items here, all this data that apply across all CCPs. We've been speaking about interdependencies. Interdependencies are, I think, a very critical topic for the industry and for the CCPs. At DTCC, we've done quite a bit of work in looking at interdependencies that we have with a vast array of institutions, some of whom are currently members that includes liquidity providers, settlement banks, investment counterparties, trade sources, so on and so forth, and we've done quite a bit of work to look at where we have exposures to each of those entities and what we can do to reduce those exposures. So some of the things my colleagues have discussed with respect to diversification of liquidity providers and liquidity sources, diversification of investment counterparties, are things that we are also doing at DTCC.

I will also point out as Kevin has said that with respect to our default drills or closeout simulations, we are looking at what potentially happens if one of those interdependent counterparties fails, so above and beyond the defaulting entity. And as is the case with all the CCPs and as required by the CPMI IOSCO PFMIs, we do look at liquidity stress testing and we look at the impact of potentially losing liquidity providers. So many of the things that my colleagues have spoken about with respect to what we need to do to manage those interdependencies, particularly in the liquidity space, we are also doing at DTCC.

I would encourage us to continue to make sure that as we move forward we coordinate with the work that's being done by the CPMI IOSCO group. We have talked about the fact that there will be quantitative disclosures that will be publicly available come the beginning of the year. We're all working very hard on making sure that that information is available, and I think that should address some of the concerns, Kristen, that you've raised with respect to disclosure. And transparency, I think for all of us, has been very important. We address it through a number of different means, including disclosure. We also have involvement from our clearing members on our various risk committees. We have multiple forums that involve our clearing members to ensure that they understand what we're doing and how we are reducing risk to the system.

MS. O'FLYNN: Richard Miller?

MR. MILLER: Good morning, Susan. Thank you. I was struck by the fact that a number of the speakers have endorsed the idea of having access to the Fed discount window in times of exigent circumstances. And I would just point out that what we're talking about when we say that is that the amendments that were made to Dodd Frank raise barriers to having access by CCPs so that it becomes a more political and more difficult process, which is a change in policy from what has existed at the Fed for 80-some odd years and the powers that the Fed had at the time of the last financial crisis, which proved to be very successful in the crisis. And speaking as an end-user that is compelled by law to use clearing services and the CCPs -- we have no choice but we have to do it -- it would be an irony of historic circumstances proportions if in a crisis a CCP faced a liquidity constraint and could not access the discount window successfully, and financial end-users like ourselves suffered damages, financial damages because of that. I think that the policies reflected in Dodd-Frank, some of them are very good, but this one I think is erroneous. I hope that we can address this in further deliberations of the MRAC.

MS. O'FLYNN: Commissioner Wasserman?

CHIEF COUNSEL WASSERMAN: Hi, I'm Bob

Wasserman, CFTC staff.

Just a couple of things. I know a number of folks have mentioned the quantitative disclosures, and as has been pointed out, those are going to be coming in no later than the first of the year, and I think that should be very helpful. I should note that CPMI and IOSCO are also doing some current reviews of the requirements in the areas of stress testing and margin and recovery and others, and I think transparency as well, and perhaps added transparency may well be part of that. Folks have been talking a lot about liquidity by sector and that is quite important. However, also in considering your liquidity arrangements, it's also very important how much you have to any one counterparty or any two counterparties because who is going to fail, assuming the arrangements are taken, don't have, you know, if you can have multiple folks who can fail just because one doesn't participate, that would obviously be quite problematic. I think you want to look at then individual failures and what coverage do you have and do you have coverage that will address essentially that you have enough despite the fact that one or two of your counterparties fails whichever sector they may be in.

Now, there is, of course, one counterparty that is considered a perfect credit in terms of depositories and that would be the central bank of issue. And those -- as Kevin pointed out, those folks who are SIDCOs are able to apply for account services, and progress has been made with respect to account services on the house side. Our colleagues at the Fed are still working on account services on the customer side, and we do hope for progress in that area.

MS. O'FLYNN: Okay. I'm just conscious of time. We'll go to Sunil, then Emily, and then Marcus.

MR. CUTINHO: I want to address a few comments on liquidity. So you know, as CCPs, we don't take that into account when we size our liquidity resources to cover the stress losses.

We don't assume that central banks will be there. The issue that I think Kevin is talking about is the things that the Bank of England has addressed. Essentially, if we are assuming -- if we're assuming that the entire repo market has failed, if we're assuming that there is no buyer for U.S. Government Treasuries, you know, sovereign bonds, then it doesn't make sense for us to assume that our clearing members will have access. So that scenario doesn't really make sense. So essentially, those are exigent circumstances. So it will be unreasonable for us to sit here and theoretically assume that a central bank will not be there because the issues won't be restricted or won't be localized to just CCPs because at that point in time you have serious issues in the financial system as a whole.

So if a central bank is providing those facilities for certain entities in the system as let's just say bank entities who have access to the Fed, then the question is, why wouldn't CCPs who have this collateral from these entities also have access, essentially avoiding a circuitous process as to going through the banking system. That's essentially what we're talking about here.

The second response -- I want to respond to a few things that Kristen brought up. I'm just a little surprised with the comments because there are a few things when we talk of transparency that are available. There is public, what is available on our website on our rule book and is disclosed openly to all our market participants, and then there is the second level of transparency is where a CCP is subject to routine credit reviews. We've had several, both from clearing members, as well clients who come and do credit reviews.

The thing about transparency is there is a line. We have to be very careful. You cannot compromise the integrity of the system. We cannot show one set of clients the risks that are brought by another set of clients. That in a sense is the problem here. So I don't think you're referring to that, but if you're talking about the total amount of resources available, that information is actually available publicly.

So if the question is on stress testing, the stress testing methodologies, all the information related to stress testing is available. I think what we're arguing about here is, you know, certain disclosures that are, you know, available through CPMI IOSCO starting in January, and that will actually give you more information at an aggregate level. Again, not giving you specific risks from each client but at an aggregate level. If it is scenarios, I think the discussion is about standardized scenarios or standardized principles and I think the argument in the industry, at least from our CCPs is principles are much more powerful because that's something that allows -- market risks are evolving and a CCP should react to those evolving circumstance and add scenarios. See, if we just rely on a standard set of stress tests that don't change, then you'll get a false sense of comfort if somebody passes that test. So that's essentially what we're talking about. So I'm just surprised that you say you have less transparency now versus your counterparties in the bilateral space.

MS. O'FLYNN: Do you want to respond to that and then move to Emily?

MS. WALTERS: Sure. So yes, the unfortunate truth is we just don't have the same level. I mean, ISDA documentation sets forth some very detailed requirements around transparency and information that's provided, and the standardization of that approach makes transparency and due diligence analysis easier and consistent across counterparties. We don't have it yet in the space. I think the disclosures that are coming in January will, if they're implemented as written, will help around -- they're not there now. They'll help around loss absorbing capabilities as well as margin methodology. In the stress testing space, the language is a lot lighter in those quantitative disclosures, so we, at the moment, don't think -- I mean, we currently don't have what we need and we don't think we have enough. You know, as someone who has been, you know, kind of doing risk management for close to 25 years now, what I would say is that I think the financial crisis lessons learned, you know, the banking regulators, you know, did learn some pretty key lessons about how to resolve, you know, financial institutions and how to assess capital adequacy, living wills, and so on and so forth. And you know, there are some limiting assumptions in the stress test, but what is very good about using a standardized approach, and to be honest, the scenarios do change all the time when they're conducted, is that the methodology is consistent, the results are reported in a consistent way, and it's very -- it's much simpler to evaluate the results when there is standardization. We also take much more comfort around a regulator, overseeing the stress tests themselves, so overseeing the results, and also the fact that there is public disclosure.

You know, we do, as an asset manager, you know, with, I would say 6,000 individual fiduciary accounts that we manage, assets on behalf of clients, we do liquidity risk stress testing on those portfolios, so we look at the profile of assets over time, of liabilities, i.e., potential redemptions, and we do all kinds of stresses to look at how the market to market of the assets can change, ability to liquidate positions, and on potential redemption likelihood. And it's a different problem set, but I can tell you that -- and we've invested over 30 years massive amounts of human capital and financial resources in developing technology platforms and analytics to do this, and it's really hard. And the results are -- I wouldn't say speculative, but these are ex-ante measures that, you know, are not easy to be precise about. So we're asking for more standardization, more comprehensiveness and oversight by regulators because, you know, we, ourselves, have experienced great difficult and complexity with applying similar types of stress tests to the assets we manage on behalf of clients. So I think the view is if it's tough for us and we've, you know, invested in this for 30 years, I think it's really difficult given, you know, the change in liquidity and the dynamic in the market for any individual CCP to do it without benefitting from standardization accorded by, you know, a regulatory umbrella and oversight function that's proven to have worked post-financial crisis for banks.

MS. PORTNEY: Hi. Can you hear me?

CHAIRMAN MASSAD: Yes.

MS. PORTNEY: Thank you, Susan. Thank you, Commissioner Bowen and Petal for doing such a great amount of work on all of this.

A few very quick comments in the interest of time. On disclosure, I think we are very much in agreement with Kristen. As a clearing member, we always can -- we come some way in further disclosure but we certainly can do a lot more. But I really want to actually, given the time we have, talk about just access to the Fed and exigent circumstances.

This is one issue where I think you will find that all market participants are incredibly aligned, and I couldn't agree more with some of the comments that Sunil, that you were just making. I think -- and the reason we're aligned is not at all because we want to take taxpayer bailout or because it's easier; it's because in the absence of that, the rules which are now being put in place are basically rule-based liquidity facilities, like CCLF or DTCC, which is highly unpopular and basically you're actively allocating liquidity out to banks at the worst possible time. Committed repo lines. Again, doing exactly the same thing at the worst possible time when the repo market might be closed down. Payment in kind arrangements whereby our treasuries and other things that are on deposit are suddenly substituted without any say for -- or sorry, our cash is substituted with other securities without any way, and again, leaving a liquidity drain on members and others. And finally, variation margin haircutting, which absolutely impacts the end-user.

So the reason -- and I think we were all saying -- you know, Sunil, you said it very well. In the absence of any certainty here, we are all spending a hell of a lot of time implementing rules and other things which are frankly just not going to be reliable at the worst possible time. And so would it be better to at least give us more clarity as to when perhaps the Fed would step in, for which institutions, and under what circumstances, especially given that the collateral we're talking about is generally treasuries and agencies, et cetera. And especially when other institutions, other central banks around the world have acknowledged that in the worst possible crisis, this is the only thing that really can be done to restore confidence in the markets.

MR. STANLEY: Hi. I want to apologize first of all for being late there. Dodd-Frank just does not slow down and there are multiple things going on that I had to attend to.

I wanted to comment on this issue of

discount window access. This is something that is very controversial for us. We have some deep disagreements with the direction with some of the recommendations from market participants here. I have to say I'm not too surprised that market participants would be aligned in getting assistance from somebody else who is not a market participant in the event of difficulty.

I do think that one thing -- a couple points. I think it's important to be clear that when we talk about the discount window, we're really not talking about treasuries. We can say around this table that we're just talking about treasuries, but what's special about the discount window is that it i's designed to take illiquid collateral from banks. It is designed to take a wide range of collateral. And actually, the Federal Reserve has plenty of authorities that are not the discount window that allow it to liquefy treasuries. The most obvious being section 14 of the Federal Reserve Act permits open market operations. Obviously, unlimited buying and selling of treasuries. I would expect in exigent circumstances the Fed would be a buyer. Section 13-13 of the Federal Reserve Act permits advances on treasuries without exigent circumstances. There's no exiting circumstances qualification in section 13-13. So these are all existing authorities that are not the discount window that allow the liquefying of treasuries.

And what's special about the discount window, again, is it accepts illiquid collateral, and the justification for that was precisely to permit banks to take some risks on potentially illiquid collateral. You know, this goes back to the purpose of the Fed as supporting farm financing and the like. Clearinghouses really do not have that need. Clearinghouses are not entities that should be investing in illiquid assets. And we just have some serious concerns about undermining incentives for proper liquidity management by permitting some kind of expedited or easily forecastable access to the Fed for liquidity. As everyone here knows, liquidity risk management is at the center of what clearinghouses do and we don't want to weaken those incentives, and we also frankly think Congress spoke pretty clearly in Dodd-Frank that this should not be a routine matter.

MS. O'FLYNN: Okay. Well, thank you, everyone for the feedback. To summarize, I think, you know, where the group has effectively -- we need a coalition of the willing to move forward is the best way to describe it, and you know, I think there is definitely, you know, as Counsel Wasserman said, you know, the PFMIs in January will create, I suppose, more transparency in the marketplace for institutions to understand a lot of these questions which are being asked to CCPs. I think what we need to be prepared for is that there may be gaps in the disclosure around what market participants want and it's effectively how, you know, we evolve together as a marketplace to see how we solve for those potential disclosure gaps. And obviously, with regards to liquidity management, you know, it's a very important topic.

CCPs are becoming ever bigger. Monetary clearing goes live in Europe next year, so volumes will just get -- will increase. And, you know, this whole topic around liquidity management, be it for, you know, investing your cash, you know, emergency liquidity access, I think it's obviously a critical point of focus for every single clearing member participant. Obviously, we've heard some quite diverse views here today, but that's the purpose of the RMAC.

So, you know, with that, I thank everyone for being, you know, as open as they have been, and we look forward to the CFTC as to how we move forward.

MS. WALKER: Thank you, Susan, for that. And the first panel is now concluded. We will start the second panel in about five minutes at 11:15.

(Recess)

MS. WALKER: Okay. So we'll be starting off our second panel now. Once again, we have Susan O'Flynn, of Morgan Stanley, who will be moderating our second panel.

MS. O'FLYNN: Okay. Panel number two is on Portability and FCM Resource Availability, a topic that was widely discussed at, you know, I think either the first or second RMAC, specifically around two kind of key areas of focus/concern.

Number one, financial resource availability, and number two, operational resource availability. There's been, you know, it's been discussed, you know, ad nauseam in the marketplace and in this particular room around, you know, the constraints FCMs have today in the new regulatory environment. And the, you know, the purpose of this panel is to understand the availability of FCMs in the event of a large FCM default. And we want to focus on, you know, I suppose, the CCP responses to the new regulatory environment and, you know, to understand portability in this new world. And from a financial resource perspective, you know, how is portability envisaged in this new world? Is there an understanding that there will be an FCM to be able to absorb the customers of the defaulting FCM? Or does portability have a plan B? Is the margin adequate to be able to support a period during which the transition of those customers takes some time? And also, secondly, to understand whether new models are emerging that may replace the traditional FCM model, i.e., is it a sponsorship model or is there potentially direct access for clients? This is obviously taking -- getting some traction in Europe, but obviously has some regulatory constraints in the U.S.

And secondly, around operational readiness with regards to porting. You know, from an infrastructure perspective, and I think Clifford mentioned that in the previous panel, you know, is there investments needed to be made from an infrastructure perspective, from a CCP perspective, to, you know, to be able to facilitate that portability, to understand whether, you know, the question of the availability of FCMs for smaller members. You know, do they have more than one FCM or is there an ability for them to have another FCM to do cost issues? And from a kind of readiness perspective, do we involve customers in fire drills today or the recommendation was that customers should be involved in fire drills to kind of simulate porting, to understand from, you know, again, an operational readiness perspective, and then also an analysis from a financial resource perspective the available FCMs for those particular customers.

So you know, I'd like to take the same format as we took before, turning over to our clearinghouse members to, you know, respond first to this, as to what you do today, you know, and how you've responded to this evolving market, because I know a number of you have commented in this particular forum that you already are responding to the shrinking FCM market and, you know, how you see this, you know, moving forward given 2018 is getting ever closer.

MR. CUTINHO: I'll kick it off. Very quickly, I think, let's start with -- let's start with -- let's take a step back and I'll share a little bit about our experiences with porting. You know, in our experience, the important thing about porting is to ensure that the customers have continued access to the markets. That is very important. And in order to do that, and this has been our experience in even a very complex event in 2011, in order to do that, the most effective way of porting actually is to port a group of customers at a time. You cannot pick and choose. We use something called a negative consent, so essentially, if the customers of the failed FCM are notified that they're going to a new home, and then the, you know, the customers maintain access but then they can discuss with the FCM and move their positions to their eventual home. So that in essence has worked out very effectively.

What are the challenges to that? I think if you look at today's environment, let's take a step back, the most important thing, our success is based on the fact that we had gross margining regime. So having margins, enough margins, financial resources associated with those customers at the clearinghouse is very important because if there is not enough margin, you will not have suitors for this customer business because there are risk discussions involved.

The second thing, and this has not come to play yet, but there is the new BASEL capital rules for the agency side of a bank's business, the clearing firm supporting client clearing. The current rules, I think, are a mistake. They treat this client risk as though it is the bank's risk. They are not the bank's -- they are not the agent's risk. The clearing firm here is acting purely in the capacity of an agent. Margin is collected, and that margin is passed on to the CCP. So it's important to actually give relief to the agency side of the business because if we don't, what has happened, or what would happen is most of these firms would reach their capacity today. They wouldn't be in a position, or they wouldn't love to take on more clients exactly when we want them to.

The option for a CCP at that point in time is to liquidate clients, which essentially is bad for markets. So we have spoken a lot about this. We have written a lot about this, and we hope BASEL at its meeting in December would take note -- would take note of the systemic risk issues related to SLR treatment of client clearing.

So we talked about financial resources. Now, let's address the operational side. Thinking of porting during a drill is actually good, but it is purely testing operational capacity. It won't be able to test the other aspects of porting. We've heard the term KYC. One of the things that we ask regulators to take this into account is that, you know, when you're porting clients in bulk, it is not possible -- the most important thing during porting is time. So you need to port it as quickly as possible. So it's not possible for the receiving firm to do a KYC on all the clients that it is receiving. So it's important for regulators to give relief to the receiving FCM so that they can do the analysis post-porting.

The second thing we talk about is information of the clients. So one of our experiences, and they've actually proposed a rule to the community and we want our FCMs to actually share information on their end clients with the CCP, used purely for the perspective of maintaining access with the end clients while we are porting. Information sharing is very important, so this is transparency going the other way around. So having contact information of end clients so that we can communicate with them during the porting exercise is very important. This is a rule that is in play. We've given timelines to our firms to comply with.

So I would like to stop there before I address new models, just to talk about the current structure and challenges facing the current structure because porting has been successful in the states through several circumstances. We have done this during the financial crisis, before the financial crisis, post financial crisis as well.

What I'd like to do here is just point out some challenges to that before we talk about other solutions.

MR. MCCLEAR: So I agree with Sunil that gross margining was, and is, a big, big step to facilitating porting. You know, we lived through Lehman, we lived through MF Global, and the first question I have on this list is, how do we facilitate continued clearing for the customer origin before porting? And it's as simple as the clearinghouse has to have sufficient margin to manage the risk so that we don't have to liquidate the portfolio. And we don't want to liquidate the portfolio. We want to facilitate porting. But to hold on to that portfolio, we have to manage the risk, and we are fortunate at Lehman and MF Global, in particular, where the market wasn't moving so we had the luxury of time. And to Sunil's time, we need to move fast to affect porting so the market doesn't move.

I can tell you just by coincidence this week, ICE Clear Credit is doing its default test, and it has a FCM focus. We have 23 customer positions and we're providing those to the FCM. The FCMs -- there are 14 FCMs. And we're asking them to review those customer positions to assess the risk to see if the FCMs are in a position to take on those portfolios. So that's practice. That will help. And then we'll go through the steps of actually affecting the porting, and we've been working on automating our systems to affect those transfers.

The other interesting thing we're doing and we've done in the past is we have a trustee. Not a real-life trustee but we have a lawyer playing the trustee to mimic that process because that's an important process. We have in the U.S. loss-sharing provisions in the 4DA and the 4DF account origins. And before we can port the margin -- we can always port the positions but porting the positions without the margin doesn't do much good to the receiving FCM, so we need to confirm to what extent we can also port the margin. So we simulate that trustee process where the trustee has to go to the bankruptcy court, assess the available resources, and then they actually issue an order and we get a letter from the trustee saying how much margin we can post. Unfortunately, that's how it works, but we simulate that. I noticed that was a question.

But the last recommendation I think is the most important recommendation, and that is the customers need to find backup FCMs. They should establish this upfront. They should be ready to port in the unfortunate circumstance that their primary FCM becomes insolvent.

MR. MCLAUGHLIN: This is LCH again. I'll just add to Kevin's comments.

The first thing I'd like to share is that operationally we can figure out the mechanics required to do a port, but as Kevin noted, you know, another party comes in before you can actually do anything, you need a trustee to opine on whether or not you can port or not. And for that reason, we have -- we hold extra margin to account for this lengthened -- possibly lengthened time of dealing with the client positions. We don't see how you can have the same length of time to margin house positions as client positions. And so this obviously is more expensive because you can't really pin it down exactly how long it's going to take to port these positions. And that's assuming that you have a home set up and a willing FCM to take these people. I'd just like to add that.

MS. O'FLYNN: It's clear that the role the FCM plays is critical here in all elements. Number one, from a buy side perspective and from, you know, an end-user perspective, and to understand the willing universe who is there to be their backup. But then it's kind of a symbiotic process. From a CCP perspective it's, you know, understanding the availability of FCMs under the current regulatory regime to be available depending on another FCM defaulting. I know, you know, from a Morgan Stanley perspective, we would be obviously supportive of, you know, resources willing to take on our large, you know, client positions, but it will definitely be challenging for large FCMs to be, you know, have a, you know, a broader platform to be able to onboard other end users. So it comes back to understanding how we bring these two together. Clearly, there's a customer concern and there's a CCP concern, and the FCM, obviously, plays a pivotal role here. And I think -- I see Sunil, you want to respond?

MR. CUTINHO: Yeah, you know, when we think of these issues, they don't occur in an instant, so there's a lot of planning that happens before. So in the U.S., we've had the benefit of coordinating with the CFTC, and if it's a broker-dealer, the SEC had FINRA involved as well. And so we have a lot of time in advance of real issues. What is important is that there needs to be, as you point out, some kind of a planning. We do "white knight" planning. So you look at, you know, the way you look at it is you can't -- because you're at a point in time where you can't disclose this to the broader market, but what you can definitely do is look at the capital position of the solvent FCMs and find a good mix, find potential homes for a failure. Okay. So "white knight" planning is something that is a part of -- so it is not a default really, per se, but it is before you get to a default.

The thing to point out is that, you know, if we are talking about the ability of FCMs to receive, we have to be very careful. So you cannot have a situation where you allow the receiving FCMs to cherry-pick and say "I'll take this client but I won't take that." That results in using a lot of time. In our experience, you take the entire book. You take the entire client book fully or subsets of it, segments of it. And then you can work with your clients. So that's a much more practical approach because clients maintain access to the markets during the time period that you're porting. It's very important. We've seen a recent experience in Australia where doing the reverse or getting an explicit consent or expecting clients to react faster and find their own homes will take much longer. Two, the extra margin also is not relevant for that kind of a discussion because in the case in Australia, it took about a month. So you have to be practical in these circumstances. So you have to take -- and the idea is to take an entire book or take parts of the book, and in our experience, we've seen FCMs actually take that and then work out the relationships with the end clients for reasons that could be know your client, credit, and other reasons, and then -- because they have enough margin to cover. The most important thing is to have gross margining, so that margin gets transferred along with the positions. That is the key.

MS. O'FLYNN: Rana?

MS. YARED: Thanks, Susan. Sorry, I wasn't expecting you to do that. I was expecting you to go to Clifford.

So I want to say a few things on the matter. You know, first, our unquestioned goal is to provide clients unbroken access to markets in times of crisis, but unfortunately, you know, this is increasingly very challenging for us, and to the point that Sunil and Kevin have made about having sufficient margin, indeed sufficient margin is a necessary but not sufficient condition to being able to take on the portfolios. And the main reason for that is the challenges that are posed by the capital rules which, you know, have been alluded to in this discussion in which many members of this Committee mentioned in our first meeting are indeed counter to the general goal of clearing more. And until we have specific resolution or the ability to move on those matters, which I understand are not, you know, in the gift of this Committee or Commission, but nonetheless worth mentioning, it's going to be very challenging. And it's for that reason, Sunil, that I think folks are concerned about having to take on the whole portfolio, because while, you know, there is a willingness to do that and an understanding of why that's easier, there is a practical reality of potentially an inability to do so which, you know, is very scary; right?

And, you know, we have begun to discuss with two of the four members up there the possibility of having named backups; right? Also, with one of you, you know, our institution has discussed or been the recipients of your comments. Do we need to socialize to ourselves and to our clients that if you don't have a backup and there's no FCM who can take you for capital, then that means you're going to get closed out. All right? This is an ugly reality, but I think the reality is important to be known so that people aren't surprised.

And so I think that gets us to the multiplied point which is if, you know, God forbid, once CCP goes -- has a default, the reality is that the clearing members that we use and our counterparties in this room, JPMorgan and Morgan Stanley use, are very likely the same entities at more than one clearinghouse. And so this heightens the importance for coordination between the clearinghouses. And I swear the B of E did not put me up to this, but you know, the Bank of England is suggesting for European clearinghouses a join drill between Eurex and LCH; have asked a whole bunch of us to appear before them to discuss in a few weeks' time, and it's a worthy discussion to have. However, I think the reality in the global system is that there is a third very large pool of risk and it sits entirely in the U.S., and so we should probably, you know, have a discussion about the reality of that and a cross- default that takes into consideration CME with the European counterparties.

And maybe the last comment I'll make on this is, you know, a bit of a red herring caution. So as this discussion has evolved, people have said to us, "Well, gosh, like, wouldn't it just be better if, you know, more people participated in auctions? That would let more people bid for portable client portfolios." And I think our response would be, "Most likely the people that are participating in auctions aren't FCMs." So, you know, having more people participate in auctions, an interesting discussion in and of itself, but shouldn't be conflated with the ability to increase portability because the entities that are nonmembers which would participate in those auctions, are very likely not to have FCM services. It's important to separate those two.

MS. O'FLYNN: Thank you, Susan. Clifford?

MR. LEWIS: Some of what I was going to cover was just covered much more eloquently in terms of the inconsistency between the capital rules and the reality of cover two. Cover two default and portability, something that Wendy said the first -- one of these sessions. I fear, and this is -- now I'm going to perhaps be a little bit rude -- that when regulators begin to deal with a world that simply can't be addressed, it does not have a constructive effect on practical things that could be improved. And the reality is porting in the current capital regime, which did not exist in the previous times when porting took place, but the idea that you can port all of the hundreds of thousands of accounts overnight is crazy. It's not possible. And if the regulators want to encourage a discussion that is fundamentally realistic, that's fine. There's a lot of that that goes on, and the risk here is that it does detract from discussing more practical, realistic scenarios as to what you would actually be able to do.

The general point I also want to make is a point that from the client's perspective, the market circumstances where these sorts of problems happen are obviously stressful, to put it mildly. Market circumstances; right? And that's, of course, part of the problem with how you build your scenarios and so on and so forth. But the fact of the matter is one of the things that the clients need to know is certainty of whether their hedges are still on. And this becomes a very important point in the kind of circumstances we're talking about. So, I mean, I think that we would be well advised to be more concerned about end-user protections and certainty of hedging in these very difficult times because absent that, I think we've kind of undermined the whole economic purpose of these risk management tools, which is to say if they're not reliable when they're most required, what's going to happen? And indeed, an unintended consequence of these capital rules is perhaps it will, in fact, reduce the amount of risk management activity by clients who have for the last -- since the invention of financial futures, been able to address these kinds of risks. This is a point that the chairman, I know, made an important intervention on with respect to a particularly -- a particularly interesting interpretation of how one has to account for cash margins from a balance sheet perspective. It applies equally to collateral. It's always been kind of a foolish part of the way the accounting has taken place in my view. But thank you for speaking up about it, but it's those kinds of issues that if left unaddressed, frankly, makes a lot of this discussion kind of silly. And I'm not even sure in the event of a crisis you'd want to be reminded that we had thought we had solutions to some of these things.

MS. O'FLYNN: Ed?

MR. PLA: Thank you. Thank you, Chairman and Petal.

Maybe echoing some of these comments and sharing an FIA perspective, I'm gratified to hear Sunil and others recognize the shortcomings and the implementation of BASEL III and leverage ratio rules as it relates to client clearing. We think that they are a concern for the reasons that we've argued. I think the concern is not -- I don't think the FIA denies that there's risk associated with client clearing activities; we just feel strongly that it's quite likely that we're poised to dramatically overcapitalize those risks, and I think that directly relates to the risk of porting. I think if we go back and we look at any previous episodes of clearing member default or CCP crisis that resulted in porting of positions. We have to remember they're all pre-SLRM implementation. So this entire regime that we're discussing, the whole notion of derivative clearing, mutualized risk, availability of portability, is untested under the rules that we're about to adopt. That should give us pause.

We have to recognize as well that when we look at the complexities of porting hundreds of thousands of accounts or checking with trustees or gauging clearing member willingness to take on positions, these things are going to be likely measured in not hours or minutes but in days. And so I think from our perspective we would respectfully request the Commission maybe consider these things and fully engage during the CPMI evaluation, margin requirements supposed to go live in 2016. I think there's an opportunity there to link these issues. So we have to question whether or not initial margin is going to be adequate in a stressed period like this considering the new complexities and obstacles to ease of porting those BASL3 implementations. I think that's the real question.

MS. O'FLYNN: Marcus?

MR. STANLEY: Well, I'm going to make

myself a very unpopular person today; I can already tell.

I just want to address this issue of capital charges, starting with the argument that client margin should not be subjected to the supplemental leverage ratio. You know, as I understand it, that margin is on the balance sheet because of gap accounting rules, and gap accounting rules would not put that margin on the balance sheet unless banks were in some ways able to take risks with it, reinvest it, earn returns from it, and possibly incur risk. And for reputational and contractual reasons, that margin is owed to the client. So unless it is rock-solid segregated in a way that in my understanding would not put it on the bank's balance sheet, then the bank is responsible for returning that margin, and there's a potential risk of loss there. So I just have a hard time seeing the argument for an exemption from the supplementary leverage ratio here. And let's remember that cash -- the supplemental leverage ratio applies to cash, it applies to deposits with the Federal Reserve because it's meant to ensure that there's a minimal -- minimal 33 to 1 level of leverage for banks based on their overall size. And holding margin for the client is part of that overall size, just like other low-risk kinds of assets are. So I don't see the argument there.

And in terms of the broader argument about capital here, I see this kind of circularity. I think Rana said that we have a goal of clearing more. I don't think that that's our goal, clearing more. Our goal is to improve risk management, and if we end up with a situation where we're mandating clearing but cleared transactions are undercapitalized or the risk management is not good at clearinghouses, then as we all around this table know, clearinghouses will become a critical point of failure because that risk is still there. And I just kind of see this argument. On the one hand clearing is great because it mutualizes risk. On the other hand, let's not capitalize that mutualized risk because it discourages clearing, which we all know is great. You know, clearing is good if it's adequately capitalized and if we provide it for that risk.

So let's figure out the real total loss exposure that clearing members are going to have to face if they actually mutualize that risk, which means assuming some of that risk that they may take on derivatives positions from other -- from clients of a failing clearing member. Let's figure out the degree of mutualization we're comfortable with and provide capital for that as opposed to exempting people from capital rules during a time of financial stress.

And just one final point. Let's remember that the capital in a failed -- we're not just talking about the capitalization here of a clearing member that's solvent that's trying to port. These rules will determine the amount of capital that's there in a defaulting clearing member as well. The more capital, the lower the likelihood of default, and the more that you're going to be able to get access to potentially if somebody is defaulting. So these capital rules are determining the viability of the clearing members who might be weak as well.

So everyone can fire at me now.

MS. O'FLYNN: Luke?

MR. ZUBROD: I'd like to address the comments both by Kevin and Rana on backup FCMs, and specifically as it applies to smaller financial entities. You know, I think the benefits of a backup FCM are reasonably clear. Certainly, our clients -- and Chatham has about 1,600 clients, about 30 of those are signed up for clearing, so mostly nonfinancial entities, some financial entities. I think what I'd like to sort of bring into light is the cost side of that equation. So, you know, we can appreciate the benefits of a backup FCM. Let's talk about the costs, because this is really a serious constraint for smaller financial entities as it relates to the decision of whether to have a backup FCM. In particular, the key cost is minimum fees that really serve as an obstacle to really make clearing cost prohibitive for many smaller financial entities. These fees generally range from about $60,000 a year, minimum, to about $120,000 or more per year, minimum, depending on the FCM and various circumstances. And so that can, for a smaller FCM, make clearing cost prohibitive. Consider someone who is doing a single hedge over a five- year period and has to sort of agree to, you know, $300,000 to $600,000 over that period just for the benefit of clearing that one interest rate swap. Now consider the possibility of doubling that by some mechanism that encourages, incentivizes, requires backup FCMs.

So this is just another constraint to navigate as, you know, we try to thread the needle on this, I think there are ways of addressing it. You know, among them a financial entity de minimis exception where if the quantity of your derivatives use is smaller than a certain threshold deemed to be systemically insignificant, then you would not be required to centrally clear those transactions or you as an entity would not be required to centrally clear. There are other potential ideas that could sort of address this concern but I think it's one that needs to be brought into consideration.

MS. O'FLYNN: Emily?

MS. PORTNEY: Hi. I would just like to, Marcus, correct or a comment that I actually think is slightly misleading on the leverage ratio. It is -- the clearing community wants to and agrees we should absolutely hold capital as a clearing member. And there are two places where capital comes into play in the leverage ratio. One is the on-balance sheet, which is subject to gap which, by the way, no one, the clearing members and no end users are suggesting that we treat that or change that in any way, shape, or form. If cash is on my balance sheet as margin, I'm going to hold capital against it and I fully expect that.

The part that we're all talking about is the off balance sheet exposure calculation, and it is in that where we truly feel the exposure is overstated if you do not recognize the offsetting nature of segregated margin that is given to us to protect against the need to liquidate a client's position. And that margin is sacrosanct. It is held at the CCP. It is required that it be held in highly liquid securities and/or cash, and it is available. The way we've explained it is to the extent that I've guaranteed a trade for a client to, say, the CME, that's $100 worth of exposure and I have to collect $10 in margin. The most I can lose is 90. I'm happy, happy to hold capital against the 90. It is overstated to say I have to hold capital against the 100. And so I just want to make sure that we're all talking about the same things because the way you're mixing both the on balance sheet and the off balance sheet, and one is just simply an overstatement of exposure. So that's one thing.

Two, just to talk a bit about the access of clearing. One question that we've talked about in terms of -- or that I've often been asked is aren't there going to be new entrants to the clearing market? Why wouldn't there be new people coming in to become clearers? Capital -- there are three things -- when we talk about a clearing member or becoming a large clearing member, there are three things that are incredibly important in order to even get yourself off the ground and start running. One is capital. Whether or not it's under the SLR rules or not, it's -- capital is important. The other is liquidity. So to the extent you are a clearing member, you are fronting your client's margin to the clearinghouse every morning, in which case you must have access to liquidity -- either your own liquidity or through facilities from other parties. Those are getting repriced and are very, very expensive. So, again, that is a barrier to entry.

And something we've all started to touch upon is operational scale. If you want to be a large clearing member, you need to have the infrastructure, the risk expertise, the technology, et cetera, and the operational capacity to join and keep up with being a member of dozens of clearing markets. This is a tough business, so when people say, well, if it's tough, why don't you just have -- won't there be new entrants? At the end of the day, the barriers to entry are really, really high. So I do think we all have to be very conscious of the fact that further consolidation among clearing members is not a good thing, and the likelihood of lots of new entrants coming in is unfortunately probably not realistic.

MS. O'FLYNN: Jerry?

MR. JESKE: Emily, very good segue into actually what I was going to say. I couldn't agree with you more. As an end-user, I'm here actually on behalf of the Commodities Market Council, which is a group of different end-users -- eggs, financial, as well as energy.

As relates to the leverage ratio you spoke of, you're 100 percent right. It's simply an issue that's not being addressed that the seg margin means segregated. On behalf of end-users, on behalf of customers, that money is ours. It's not the banks. This isn't about the banks moaning about capital restraints. They actually have a negative impact on the entire market.

That being aside, the point of why aren't more people getting involved in the market to become, you know, clearing firms or prop clearing firms? I think a couple very, very helpful comments around the table have been cost. And that was three things I was going to say: Cost, cost, and cost. That's why.

And you touched on the IT component of it. You touched on the operational risks. When you're not in the business of being a FCM and you're being pushed into becoming a FCM because of the capital cost that's out there under BASEL III, then you have to look at how can you do this for your house? If you're going to do it for house accounts, it really doesn't help what we're talking about here in terms of portability because if you're becoming a self-cleared entity, if you're going to be part of that pool, you really don't have any interest in taking agency business. You have an interest in taking a failed -- I'll go back to an example years ago. Some group had a large portfolio and so you had to find suitors who were going to take that on. Well, then you're talking about -- I think Clifford mentioned what sort of hedges do you have associated with those derivative positions?

So now we're talking about clearing swaps as well as clearing futures. And what's the connectivity to the end-user's ability to take on the entire portfolio? Not just the derivatives portfolio but a portfolio associated with physical exposures where the interplay with your banking relationships is another factor that I don't think we've really addressed here. So if you're going to take on a derivatives portfolio, as well as a physical portfolio, you have to get the approval of your lenders. And so there the interplay comes in.

And one other thing that I think the Commission could address, when I say "cost," is the regulatory cost. Ownership and control reporting, another cost associated with a barrier to entry. Is it a necessary barrier? I don't know. It certainly is a cost though. It's an IT build. It's an infrastructure. It's a head count. And what's outed there in the Federal Register as far as what that cost really is, is completely inaccurate. That cost is 10 times the amount that's been portrayed to the public. So I really would implore the Commission to think about those matters because everything I think we've said in terms of diversification would be a good thing for the marketplace, but if these barriers to entry, as Emily has pointed out, aren't dealt with, I do think it's unrealistic.

MS. O'FLYNN: Kevin?

MR. MCCLEAR: I just quickly wanted to follow on to Emily's point and establish for the record that the clearinghouses are that rock solid segregation. As Emily pointed out, that customer margin gets on-posted to us on a gross basis. We hold it. We don't leverage it. We don't reinvest it. Bob, hopefully some day we can put it up at the Fed. It's rock solid segregation.

MS. O'FLYNN: Dennis?

MR. MCLAUGHLIN: Yeah. I'd just like to mention a possible solution to this. We agree with all the problems that have been raised. The key problem for us is time because once the member defaults and you have this client portfolio to deal with, it could be quite large. And so there must be a concept of life support for the client over the period where you're looking for a home for the client, however difficult that is. So we've begun looking at potential solutions, like forming a, if you like, a fictitious clearing member, because after all, the client is posting margin every day that ends up in the clearinghouse and is segregated. So that client is probably performing okay. There must be a mechanism to continue posting margin for those portfolios while we figure out what to do with it. So that's a possible way to at least defer the end solution.

MS. O'FLYNN: Marcus?

MR. STANLEY: I'm more than open to the idea that there are details here that I don't fully understand, but I can say to you that some of the banking regulators are not under the same impression as the people around this table about the level or security of segregation that's going on. And they also seem to be under the impression that it is possible to remove certain kinds of leverage from the supplemental leverage ratio depending on the level of segregation that you do. So I may have been misinformed there, but I will go back to them and have that conversation again.

MS. O'FLYNN: Sunil?

MR. CUTINHO: So we didn't have to shoot at you for you to consider that.

I was going to address some of the things that Emily talked about, but going back to -- and I don't want to beat that point to death but I just want to go back to something else. You know, it's easy to assume that some people can clear for themselves, self-clearing, but that is beyond reach for a vast number of clients because of their charters. They cannot participate in mutualization. They cannot become a clearing member. In some cases, you know, the tolerances for paying the CCP on time cannot be met, and I think that was the point that Emily was making as far as liquidity. So it's important to keep that in mind so there is no -- having clients self-clear is not a silver bullet solution for this problem. That's why it's important to get this kind of relief.

And one thing Marcus, from a risk management perspective, you know, we're not asking for a reduction of capital as Emily pointed out. What we're saying is when a market participant puts on risk at a CCP, they actually pay margin for it. That is capital. And that is capital that is used solely for the purposes of covering the risk explicitly set out. That's what it is. That margin actually is passed on to the CCP. So when you count as capital to cover risk or collateral to cover risk, you have to take into account the margin that is collected by the client. So that is essentially what we're talking about here. If you don't, then here are some perverse outcomes. Essentially, every hedger, directional participant, will end up being the most risky from an exposure standpoint in this theoretical reality, which makes no sense. It's the hedger, not the ones who have balanced books or hedged books or a market maker who has a flat book. So they're not the ones. The ones with directional risk end up being treated as the most risky, which is perverse, which makes no sense. So that in a sense is what we're talking about.

We're not talking from the perspective of cost. We're not talking from the perspective of a principal side of a bank's business. We are purely talking about the agency side of a business which is actually providing access. Without that, you will have further concentration in market because some clients will just step out. The markets will become far more risky.

MS. O'FLYNN: I'm sorry. Jerry?

MR. JESKE: I was just going to follow

up on your point on the hedging, and maybe I didn't speak to it quite well enough. But when you're looking at those hedgers in the market, you're really looking at their total portfolios. And those portfolios are a lot more complex than what we're just looking at as a spec account; right? But in truth, if self-clearing were easier, if the barrier were less, you would be looking at an event where a liquidation of a hedger might be a little bit more straightforward unless systemically risky to the entire operation of a CCP. So again, that barrier to entry is something that, you know, hopefully, collectively, the industry can address. But, you know, if it is unrealistic, as Clifford said, we're not here to talk about things that really can't happen. But to be able to look at this in terms of the hedging world, you really do have to take back the physical component of why the derivatives market exists. So to uncouple that is, I think, a bit short sighted.

MS. O'FLYNN: Commissioner Massad?

COMMISSIONER MASSAD: Thank you. This has been a very, very good discussion.

I wanted to just clarify what I have said on this issue so people don't -- so people are clear on what my own position is here, particularly on the SLR. Because, first of all, I strongly support having stronger capital requirements for banks, and I appreciate the goal of the bank regulators in having the SLR as a nonrisk-based backstop to those requirements. My concern is in the way that it does measure the exposure of a clearing member, and the affects that it may have on our goal of promoting clearing. And to that goal, Marcus, I couldn't agree with you more. Our goal is not just to increase the amount of clearing; our goal is to mandate clearing where we think it makes sense, meaning standardized swaps where we feel promoting clearing or mandating clearing can reduce the overall risk in the system, but I've been very clear about saying we're not going to simply mandate a lot of products just to increase clearing. And in fact, we need to be very careful about what we mandate.

But as to the SLR, I think Emily did a great job of explaining that there are these two aspects of it. And on the cash on the balance sheet, yeah, I'm not calling for any change in gap, and I recognize how gap does treat it. I think, though, what I have noted is that the cash that's taken by a bank and then actually given to the clearinghouse and held by the clearinghouse isn't being invested by the bank. And as a number of people have noted, we'd like that cash to actually be sitting at the Fed. The Fed is still looking at that issue. But, you know, there are issues in terms of the clearinghouse members' liability to the customer, and that's why I think people are working on whether there is a derecognition solution consistent with gap depending on what that obligation is.

The other piece of it is just the overall way you measure the exposure. And right now, the way the SLR works is you take a notional amount versus a fixed factor. And I think given the way clearing really works, given the way the exposure is market to market daily, the collateral, you know, you must post a variation margin and so forth, you know, I think we have to really look at whether that makes sense. Is that really a proper measure? Now, again, this is where you come in to kind of this tension where the SLR obviously isn't meant to be risk-based. On the other hand, you can't -- need to have a measure of exposure which is realistic because the fact of the matter is that large institutions, you know, this may not matter that much to the overall SLR and the institution, but they're going to look at business line by business line, what is the impact? And I think that's where we're running into the concern, and it all comes back to the comments that Luke, and Jerry, and others have made about the importance of people being able to hedge and whether we're going to continue to have a market structure which, you know, facilitates that.

And this also gets into the question of what is the overall right amount of margin, and this is why, you know, it's tied to our discussions with Europe on equivalents, where I, you know, I've been very staunch on the issue of the fact that because we have gross margining, that's much better I think from a portability standpoint, from a protection of customer standpoint as a number of you have made, Ed, and others have said, in terms of facilitating portability also. Now we're in a discussion about whether, you know, there should nevertheless be more house margin and even using a standard for house which is higher than customer which is the reverse of what Dennis and Ed and others have pointed out.

So all of this comes back to trying to calibrate these requirements. We are putting in place an entirely new system in many ways, and as people have said, it's not been tested, but I think we're just trying to balance some different objectives here. And to that extent, that's why I have said let's at least be open to looking at how we're measuring this exposure and making sure we're getting it right.

MS. O'FLYNN: One of the other recommendations was looking at the emergency of new membership models, and obviously, it's not a topic that we have discussed here today but clearly it leads us to needing to analyze that. We've seen direct access models evolve in securities finance transaction clearing which allow restricted access to CCPs for certain kind of real money accounts who obviously, as you said, Sunil, can't be subject to mutualized risk and they have certain charter restrictions. But it comes back to, again, what Emily said, there needs to be a sufficient amount of capital. There needs to be, you know, certain kind of minimum requirements. So does that result in a solution for the bigger end-user but we still have, you know, it's not a natural solution for the smaller end-user because of the operational resources required around becoming a direct member.

Obviously, in Europe, it's evolving as well potentially in the derivative space, but clearly a lot of the kinds of concerns that people have highlighted here will ring true and it may result in, you know, there being, you know, an alternative solution which means that larger customers have another way whereas smaller end-users necessarily are more concentrated to the existing FCM members in the market. And then it comes back to the question of portability and those customers actually, you know, using those FCMs or having a backup arrangement in the event of an FCM default. Does anyone have any views on that? Because I'm conscious we're running out of time but we haven't really kind of discussed the direct access model at all.

MR. MILLER: Just briefly, Susan. I mentioned this in prior meetings that large financial end-users like ourselves would be interested in a direct access model provided that we were not liable for any contributions to mutualized risk. And speaking from a legal perspective, maybe Bob has an idea on this, that it's my understanding that the problem with that ultimately is the bankruptcy code and the potential that even a direct access with no contractual or rule-based mutuality might still be considered funds and therefore on the hook for mutualization.

CHIEF COUNSEL WASSERMAN: If you are a direct member of the clearinghouse, not going through a FCM, then you're not a customer and you don't have the bankruptcy code issues with respect to the FCM. Now, whether it is feasible to have something where some folks are contributing to the, you know, if somebody contributes on your behalf to the mutualized loss, then that could be feasible. I think the problem is if everyone says, "Well, actually, I love this clearing membership thing but this mutualized loss, I'm not willing to do that," then you might have some practical difficulties.

MS. O'FLYNN: Rana?

MS. YARED: Thank you, Susan. I would

love that world, too, to be honest. But I think it poses a lot of very practical challenges. So one of the CCPs around the table and, you know, for confidentiality reasons I won't name them, you know, went to one of the major regulators with a model that indeed did propose direct access in a nonmutualized basis for entities that were contractually unable to mutualize -- that's a mouthful -- and that included like an alternate waterfall and all sorts of specifications. And the regulator, you know, came back with really the same point that you just made, Bob, which is if you have a whole bunch of entities that are willing to join the CCP directly but only a handful of entities that are actually willing to mutualize, how does that actually work and how do you compensate the willing mutualizers for, frankly, the risk and the monetary loss that they're taking. And so, Emily -- sorry, Susan, this like takes, I think, a whole separate session because the principle is very much accepted by a lot of people but the practical implementation is very challenging, not just on the mutualization issue but also on issues of default management participation, whether, you know, in a multiple default event is the book of a nonmutualizing party juniorized or closed out versus the book of someone who is mutualizing and has put up risk and whose margin and default fund are available as part of the resources of the clearinghouse, so there's a lot of detail behind the proposal that makes it more challenging just saying like support or nonsupport that are worthy to be worked through. And as you point out, the securities servicing world on the equity side has a model in proposal that is actually live. It will be interesting to see if any of those specifications are actually applicable in the derivatives of futures world.

MS. O'FLYNN: Now, given securities finance transactions, it's a principal transaction. There is a quasi-form of margin there. So I absolutely agree with you that the challenges of translating a similar model to the derivatives space seem unlikely. I would assume a sponsorship model will arise, but obviously that has its own regulatory constraints currently as well.

MS. PORTNEY: The only thing I would add to those comments, generally, the new membership models that we're seeing are potentially providing greater access to the buy side, but then to everyone's point, you have to be careful about how that is actually happening. Generally, it's off the back of the clearing member. Someone still has to guarantee that transaction. So the one question we would raise, are you just adding more participants and more risk into the system off the back of basically the same clearing members? I think it will be wonderful to come up with another model that solves this conundrum, but I'm not so sure that we've seen yet the model that quite does that. And certainly, none of the models solve back to our original point the capital implications we're talking about, because as long as the clearing member still has to guarantee some form of participant, whether it's sponsored or not, it doesn't help.

MS. O'FLYNN: I think we have time for one final comment. Sunil?

MR. CUTINHO: Yeah. I think the reason that you have relief in the repo world, a secured financial transaction as BASEL III explicitly calls that out. It basically says if an institution is acting purely in the capacity of an agent and if the margin is outside the control or the access of the agent, then it can offset the exposure. I think that is what we are seeking for the derivatives world as well. So, for some reason we have something, a treatment that is being accorded to the SFT world but the derivatives world was left out. So I think it works the same way. So to the extent that the margin is, as Emily pointed out, outside the control and is not used to level up the institution, it's simply passed on, it should be given as an offset. So there is a precedent out there. It's just that it's not been given to the derivatives space. And there is no risk reason not to do that.

MS. O'FLYNN: Okay. Thank you, everyone, for your comments. We will close this particular panel on that topic now.

There were three other recommendations which were part of the original five, which I will just run through very quickly. Petal has mentioned that there may be, you know, forthcoming panels or discussions at a future MRAC but not for today.

The three remaining recommendations were action process consistency and transparency. So this concept of a CCP playbook, which will probably be minimum standards based with some amount of customization depending on the product. Obviously, in response to a number of our colleagues' comments on that particular point. To create clarity for, you know, clearing members and end-users to understand -- this leads into the second point -- around what will actually happen each time there's an auction or a fire drill?

What are the role sand responsibilities, and what are the potential ramifications if you don't participate or, you know, you fail to submit a bid?

The fourth recommendation was around buy side participation. The recommendation was that buy side participation should be possible in an auction, provided that the buy side were subject to the same incentives, both financial and procedural as a full clearing member. So the concept of having to be subject to generalization of a sum that would be contributed if you wanted to participate in the auction. So again, it comes back to this concept of having some amount of -- to use the phrase but not in its traditional form, some "skin in the game," with regards to buy side -- with regards to auction participation.

And then the fifth one was around default management committee participation. Ultimately, what I think a lot of the Committee wanted was almost like a register as to understanding who sits on what Committee. Clearly there's a number, you know, as institutions continually reinvent themselves, the depth of intellectual capacity to be able to outsource to CCPs becomes more challenging. So to ensure that there is sufficient clearing member personnel to be seconded to CCPs in the times of stress, to understand, you know, the process of, you know, eligibility, is it consistent among CCPs? How often is the turnover of those personnel? And also as an obligation from the clearing member perspective. The clearing member should be obligated to notify the CCP if that personal person effectively starts trading in another market or effectively leaves the firm. There's an obligation of the clearing member to ensure that there is a firm representative, you know, for the period of time in which they've signed up for.

And then the last particular point on that was around, you know, and to ensure -- and I suppose this comes back to clearing members should be incentivized to second people in times of stress. So it comes back to the importance of this register and it becoming, you know, truly sacrosanct as the play to form part of the overall playbook within which if there is a large clearing member default, everyone is very clear as to roles and responsibilities. And you know, it would hopefully enhance, you know, and allow the option process to be more efficient. And that's it.

MS. WALKER: Thank you, Susan. And as mentioned, we will be discussing those issues in future MRAC meetings. Thanks again to Susan for leading this effort and getting these recommendations put together. Definitely given the diversity of viewpoints, we can see that it definitely took some time and focus in order to get these recommendations out. Thank you again.

We'll have a 10-minute break before our third panel, which will start at 12:30.

(Recess)

MS. WALKER: Welcome back. We'll be starting our third panel now, which will be led by Gerald Beeson, who is the chief operating officer and chief financial officer at Citadel.

MR. BEESON: Good afternoon. Our third panel will be Other Suggestions, so a few different presenters that we have for buy side perspective on the issues we've been talking about today and throughout this Committee. The first presenter will be Angela Patel, who will be presenting our buy side perspective on CCP risk management. Bill Thum from Vanguard will present SIFMA's Asset Management Group perspectives on CCP risk management, followed by Kristen Walters from BlackRock, who will give BlackRock's perspectives on these issues as well.

With that, I'll turn it over to Angela.

MS. PATEL: Thank you for the opportunity to discuss ongoing concerns about the financial risk management of central counterparties. My areas of responsibility at Putnam include oversight of the activities on the fixed income trading floor, including fixed income trading operations and strategic initiatives. I'm directly involved in risk assessment on both a counterparty and transactional level, and I am also directly involved in negotiating documentation with potential trading and clearing partners.

Derivatives are not new instruments. They've been an important tool in portfolio management for decades. The primary use of derivatives is to manage and hedge business and/or financial risk. The structure of a derivative contract can provide protection against directional changes in the value of the underlying assets, be they physical commodities, stocks, bonds, indices, interest rates, or currencies. Because of their synthetic nature, the protection can be obtained without buying or selling the underlying asset; thus, they have the ability to both hedge risk and to benefit from advantageous price movements.

Prior to the implementation of the regulatory reforms mandated by Dodd-Frank, derivative contracts were transacted in one of two ways. As an exchange traded derivative, a standardized contract on a recognized exchange offering transparency into the market, the contract terms were nonnegotiable and the prices were publicly available with the exchange acting as the counterparty. They could also be transacted as an over-the-counter derivative, which is a bespoke contract negotiated between two parties offering little transparency into the market with the terms of each contract privately negotiated and subject to the ISDA and collateral documentation executed between each pair of participants. And I know that we all know this but it's important.

ISDA and collateral documentation were a key element in what we had in evaluating counterparty risk, and although both types of transactions still occur today along with a third, which is under regulatory reform we must execute and clear certain designated derivative contracts in the manner prescribed by the regulations, and we have to hold these designated contracts with a central counterparty. And while the use of electronic trading has presented an opportunity to make execution more efficient, the concentration of clearing activity among just a few clearing members and CCPs has created additional unintended risk in the market.

I want to be very clear that the concept of central clearing is a positive one, but without a clean look into the resiliency of the CCP in a stress situation, an understanding of the tools available for CCP recovery in the event of a member default, and a clear resolution process should a CCP itself fail, asset managers are left in a very real sense worse off than we were before the regulation.

Prior to central clearing, transactions were subject to the executed ISDA and collateral support documentation. This documentation spelled out the terms under which we were protected, including credit rating requirements, funding requirements, and valuation requirements. The documentation also outlined protections that were afforded the parties should there be a question of viability. In addition, it detailed the rights that came into effect in the event of insolvency. Counterparty stability and risk were of paramount importance. With a cleared contract, asset managers no longer have a look into the stability and viability of our counterparty. Factors we cannot see include the resources the CCP itself has made available in the event of a loss scenario, the transparency into the margin methodology employed, and a detailed understanding of stress testing, including the results.

As detailed in the AMG letter to the CPMI secretariat and IOSCO, a letter which was also directed to representatives of the CFTC and the European Central Bank, the implementation of the principles assessment for financial market infrastructures has created a weakness in the framework, and the resulting regulations due to the lack of transparency into risk management deployed at CCPs. For a more detailed discussion of this, I turn it over to my SIFMA AMG colleague, Bill Thum.

MR. THUM: Thank you, Angela. Thank

you. As Angela said, I'm Bill Thum. I'm a principal at Vanguard responsible for derivatives legal and regulatory matters. Vanguard has been a strong supporter of the CFTC's reform initiatives, including the reporting, clearing, margining, and exchange trading of swaps. We were especially involved and worked with Bob very closely in the CFTC's clearing rules with a focus on margin protection and LSOC, enhanced customer protection, and the residual interest rule.

We're grateful for the CFTC's continuing efforts to craft a protective environment for derivatives clearing, especially as now nearly all of Vanguards swaps which are used for hedging and risk management and for cash management are centrally cleared. Today, I'm here representing SIFMA's Asset Management Group. AMG members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector pension plans, and other fun types.

CCP resilience, recovery, and resolution are critically important to AMG's members when clearing derivatives used for managing or hedging investment risks. Asset managers must assess counterparty risk, including CCP risk, when making investment decisions for clients that include pension funds and mutual funds for which regulatory directives require managers to protect invested assets, including from the failure of a CCP.

SIFMA AMG has closely followed development of the PFMIs and the public quantitative disclosure standards for central counterparties, and on October 23, 2015, submitted a letter to the CPMI and IOSCO with their recommendations. I think the letter has been included in your materials today.

We applaud the expressed intentions in the quantitative standards to enable stakeholders, including authorities, participants, and the public to compare -- to be able to compare CCP risks it controls, have a clear, accurate, and full understanding of CCP risks, understand CCP systemic importance and its impact on systemic risk, and to understand the risks in participating in CCPs. That being said, AMG members believe the implementation of the PFMIs by national regulators to date has lacked consistency, standardization, and transparency, and do not allow AMG members to compare CCPs across products and regimes.

The fundamental purpose of AMG's recommendations are clear. Incentivize behavior so that CCPs are resilient. And also provide sufficient transparency to permit CCP customers and asset managers who invest their funds to make informed decisions on the risks presented. SIFMA AMG therefore calls on CPMI and IOSCO to set minimum standards and not just principles for risk management, stress testing, and financial safeguards. Enhance safeguards to address scenarios where risk from one CCP could cascade into other CCPS. Scenarios where risk from one clearing member could cascade across multiple CCPs. Scenarios that take into account how many CCPS clear a given product or an asset class, and how many clearing members each CCP has.

In terms of transparency, require the public reporting of stress test results against the minimum standards, and use the results to adjust required CCP total financial resources to withstand financial distress. In terms of skin in the game, CCP capital commitments must be standardized, commensurate with the risk managed by the CCP, fully funded, and transparent. In terms of recovery and resolution, establish clear standards for the point of no return at which a CCP can't be saved. Positions should be liquidated and margin should be returned. And finally, in terms of customer margin, a nondefaulting party's initial and variation margin should never be at risk or used in a CCP disruption.

In terms of minimum standards, SIFMA AMG believes the quantitative disclosure standards are a good starting point in identifying appropriate areas of risk. We look for greater granularity with respect to the approaches to apply such risk plus minimum standards, not just best practices, and not principles, to apply such approaches. More extensive, detailed, and independently verified stress testing of the approaches against the standards. More regularized public reporting of the stress testing results to allow market participants to make informed investment decisions.

The letter itself has detailed recommendations, which we ask the Commission to review and consider. Some of the key points are clear standards should be set regarding the appropriate level of CCP financial resources. The timeframe for testing of the sufficiency of those resources. Further specificity should be provided regarding the use and reporting of stress test results. Regulators, CCPs, and other market constituencies should jointly develop minimum standards for CCP stress tests. In addition to the standardized stress tests, CCPs would also be required to perform tests based on their historical and evolving practices and to test according to their own unique profile. Additionally, test standards should include global CCP stress tests that focus on the areas where risk from one CCP could cascade into other CCPs or risks from a clearing firm overlap could cascade across CCPs. CCPs should be required to obtain independent validations of stress tests and risk management models at the outset and on a semi-annual basis. CCPs should be required to increase frequency of stress testing during times of market stress. The CCPs should be required to disclose stress testing scenarios, including the relevant inputs into those scenarios, pricing data, correlation, liquidity conditions. The relationship between stress testing and the size of the guarantee fund and a summary of the stress testing procedures. The responsibilities of the Risk Committee and the standards used should be defined and disclosed. Stakeholder committees should be required to include representatives of the different interests, sell side, buy side, asset manager, corporate end-user, and others, and the CCP should be required to consider their input on risk management.

In terms of large customer transparency, it's been talked about that the CCPs currently provide such transparency to their largest customers, but this is very different from clear, uniform standards and stress testing against those standards and disclosure of the results of the stress testing to all customers to create a level playing field and incentivize best performance.

A CCP's financial safeguards should be risk-based, funded, and transparent. The capital commitment to the guarantee fund should be standardized and assessed in a robust manner, and commensurate with the risk managed by the clearinghouse. Given the current and growing role that CCPs play in risk management of derivatives, current CCP guarantee fund contributions are generally insufficient and should be increased.

CCP contributions to the guarantee fund should be mandated where not already in place, and should be set at minimum risk-based level. The PFMIs and standards set by the regulators should require prefunding of certain financial resources available to the CCP.

Clearing firm assessments, contributions to the guarantee funds should also be prefunded and held in escrow accounts or by some other means for the funds to be readily available. CCPs should disclose in detail the totality of resources available for loss absorbency, including a CCP's capital commitment to the guarantee fund and the size of the guarantee fund in the event of a clearing firm default.

As Angela said, the recovery measures should be robust and clear. CCP recovery measures should be clarified and enhanced. CCPs should be required to establish clear rules for portfolio auctions in advance of a recovery event that permit the participation of clearing firms, as well as other market participants, specifically those with expertise in the asset classes composing a CCP's portfolio.

When default management fails, the CCP should quickly transition from recovery to restitution in order to protect the CCP's customers. Regulators should establish a clear standard as to when the point of nonviability has been reached and the CCP should be closed. The point should be when the clearing member fails and the auction process fails to allow the CCP to rebalance its book. When the recovery measures have failed, there must be an established, clear, and rapid process to close out positions, including immediately establishing a tariff price to limit end-user losses and systemic impact.

In terms of use of customer margin, haircuts on initial margin and variation margin are both in the event of a recovery. The purpose of margin -- we have to keep in mind, the margin addresses market risk of a position, the volatility of a position, or the credit risk of a customer. It's inappropriate to tap customer margin in the event of a disruption. Customers have no ability to assess the likelihood of disruption and loss of margin. We need to incentivize customers. Well, by accessing margin in the event of disruption, you would effectively serve to incentivize customers to leave a CCP at the earliest point to avoid the risk.

Use of margin in recovery makes no sense as effectively the risk management has failed. In other words, when considering the backstop of customer margin at the end of a recovery is illogical given the failure of the CCP at that point confirms the challenges with respect to risk management that the CCP faces. Margin cannot be relied on as an ultimate backstop as it won't be there. Customers will close out or port their positions in advance of disruption. Instead what we need is to mandate clear disclosure margin methodology, the assumptions related to the methodology, and the performance against those assumptions.

In sum, customers are mandated to clear

as Angela said, and given that mandate and limited options, regulators need to mandate strict rules to address CCP risk. In terms of standards, we need to set minimum standards for risk management, stress testing, financial safeguards, set more granular stress testing, inputs into testing scenarios, cross CCP and cross clearing member risk scenarios, and provide full transparency of performance against the standards. And finally, AMG members strongly believe that we should not allow access to customer margin; instead, set standards for recovery, define the point of no return, and move into resolution and position liquidation and a return to the margin.

Thank you.

MS. WALTERS: Thank you, Bill. So I represent BlackRock's Risk and Quantitative Analysis Group, a team of 250 people globally responsible for investment and market risk, counterparty credit, and concentration risk, operational and technology risk.

As an active member of SIFMA AMG,

BlackRock supports all of the recommendations that are in the SIFMA letter. I would encourage everyone in this room and also the commissioners to please review the comments as they were unanimous from all members that participated, and I think they reflect an aspect of the CCP resiliency issue that we've been discussing that hasn't been addressed in as much detail in this group until now.

We do feel it is critical for the end investor's voice to be heard in these discussions, and we are actually not the end investors but we're representing them. And in many aspects, they are actually the public or the taxpayers in this context, and when we talk about using, you know, a variation margin or initial margin, in the event of a default, that's kind of tantamount to placing a tax on end- users of products which we feel is very, very inappropriate.

So I just want to add some additional color to some of the comments that both Angela and Bill made. First, we believe, as a firm, that CCP loss-absorbing resources are currently insufficient in both size, as well as transparency around the actual amounts of them. We feel the default waterfalls need to be strengthened; that market participants need to be ascertained that loss-absorbing resources will be available in peacetime and wartime. One thing we saw from the financial crisis is that what you think could happen based on history or might happen, can in many instances be less extreme than what actually happens in a crisis scenario, which I think illustrates the conversations and dialogue we've had around interconnectedness and the fact that the clearing member community is actually compressing and it's difficult -- the barriers to entry are very real. We should all be listening. You know, when I hear, you know, Ron or Susan and Emily from, you know, large, sophisticated institutions that have been in this space for a long time tell us that it is challenging, difficult, or potentially not possible for them to port an FCM. I think that's something we need to listen to very closely. We're not proposing rolling back regulations in capital. All of those regulations were done for a very important reason, but there are implications of those, and I think we can't put our heads in the sand and think that if there is a default of a major clearing member, that there is going to be a multiple -- another clearing member available to step in, and also need to recognize that these firms are all, you know, FCMs in every single one of these exchanges globally. So it's a very real issue.

Therefore, what we would recommend is significantly increasing the CCP's risk-based contribution to the guarantee fund, which in all cases is quite small today, and insubstantial -- not substantial relative to the amount of capital that other regulated financial institutions need to hold aside against potential losses.

We think that additional contributions to the guarantee fund, as well as requiring that clearing member assessments be prefunded would enhance the loss-absorbing ability of these guarantee funds. And we think this will incentivize the CCPs to at all times have robust risk management systems and processes in place and align incentives between the CCP, clearing members, and market participants. We should not forget that CCPs today are not neutralized entities that are operating on a not-for-profit basis. They are for-profit entities that benefit from the clearing mandate and have done so -- sorry, you're waving your hands on the other side of the room. Pardon?

MR. GRAY: Just, sorry. The DTCC is a member- owned utility.

MS. WALTERS: Yes. So in many instances, the CCP are actually for-profit entities that have benefitted quite significantly from the clearing mandate.

The second thing that we advocate is increased transparency and consistency, and we talked about this previously in the session. You know, market participants need increased transparency into the risk management practices of

CCPs. As a fiduciary, BlackRock assesses the credit worthiness of the counterparties our clients face, including CCPs. We do not have access currently to the same degree of information as we do with bilateral counterparties. Increased transparency for the swaps market was a central tenet of Title 7 of Dodd-Frank. While we welcomed the improved disclosure expected with the CPMI IOSCO's quantitative disclosure requirements, we believe additional disclosure requirements are still needed.

As I mentioned earlier in the first panel, we still require stress test details, relevant scenarios considered, and inputs into the process, specifically risk factors and shock levels used and relevant pricing data and correlation and liquidity assumptions applied. We also need more detail on results. This would include publishing results beyond the top two along the lines of the top five to 10 counterparties concentration disclosure requirements. We would also want to see results from independent stress test validation. Further, we believe risk management processes should be harmonized across CCPs. This includes having stress testing subject to be independently determined standards consistently applied across CCPs and subject to regulatory oversight with results publicly disclosed. Ultimately, meaningful harmonization would require that mandated clear products clear at a minimum of two CCPs.

The next point we'd like to make, and I've made it before, is that the margin of nondefaulting counterparties is not an appropriate recovery tool. In fact, it's highly inappropriate and something that should never happen in this space. Initial and variation margins should never be used to cover a shortfall in a CCP's default waterfall. We've had conversations about whether variation margins should be included in the default waterfall, moved up from a buy side perspective. The answer emphatically is no. This is wrong, and again, tantamount to taxpayers essentially absorbing losses of a default.

I think one thing that we'd like to make a point in this context is when you think about variation margin gains haircutting, it's important to remember that broker- dealers, their risk positioning is generally flat, so the concept of VM gains haircutting is one that predominantly applies to end users, so clients of BlackRock, such as pension funds and institutional investors who are again representing taxpayers, as well as commercials, and this positioning by its very nature is directional, and therefore, application of variation margin gains haircutting directly affects end-users, not broker-dealers.

And I just think to clarify once again, and this point I do think seems to be lost -- has been lost in this debate, is that variation margin primarily at risk of being haircut is the property of end-users. It is not a pot of windfall gains that happens to be sitting at the CCP on any particular day. Haircutting amounts to a random tax on market participants, particularly where those participants have been required by law to use CCP services.

Finally, on the topic of recovery versus resolution, I think I've mentioned this in prior discussions and BlackRock's been very vocal around this, we don't like it when any financial institution fails, but we do know as part of the financial crisis that we've adopted and successfully used -- people can argue about how successfully, but we know how to resolve a bank or financial institution. And I think in the context of CCPs, and particularly given some of the issues we've talked about, you know, FCM portability and just the practical realities of whether or not that's feasible in today's markets, CCPs should be allowed to fail and should have resolution plans that include public ex-ante liquidation procedures. All market participants, including CCPs, should be allowed to fail while ensuring protections are in place to avoid systemic risk and to protect end investors.

Maintaining the continuity of services

of any one CCP is not the key to avoiding the next financial crisis. The failure of a CCP -- and again, I've said this before -- reflects a flawed risk management process, which will impact customer confidence in the CCP on a forward-looking basis. This challenges the very viability of recovery. The majority of our investors would prefer to be money good rather than position good in the context of a troubled CCP. So in the context of recovery versus resolution, if recovery is straightforward and practical, then certainly we would support it. However, at the point where recovery is not viable, we think that this concept of money good versus position good is extremely important.

As soon as the CCP has reached the point of no return, no goods are received for positions or the cost of replacing the positions is likely to exceed the CCP's resources. We believe that a resolution process should be immediately invoked by the CCP and relevant regulators.

Thank you.

MR. BEESON: Okay. With that, we'll open up to other comments from participants.

Sunil?

MR. CUTINHO: I don't know why I'm the first to raise the tent. Everybody else is quiet.

Thank you for that. Actually, I'd like to clarify a few things. When you say "loss absorbing resources" when there is a default, actually, the default is margin. The default is guaranteed funds. And then you have the CCP's own contribution, plus the mutualized pool. It includes both prefunded and assessments. That is the loss of job incapacity to manage a default. So I don't know why there is only a reference to CCP capital. So when you say it's insufficient, I'm presuming that you're pointing to CCP's contribution is insufficient. Yes? You are not saying the amount. Okay. I see head nods. Okay. That's fine. Okay. I just wanted to clarify that. The assessments to be prefunded. So, and then there is another team that talked about no sufficient disclosure. The size of the prefunded assessments is actually cover two. Two largest failures under stress events, and the assessments cover number three, four, five, and so on. Right? So you're suggesting that the prefunded resources should include failure of all clearing members?

MR. THUM: I think that one point that I made repeatedly was in addition to looking at the failure of a single clearing member, the stress test should consider, and the scenario should consider the failure not only of a clearing member to a clearinghouse, but also the fact that that clearing member may be failing with respect to multiple clearinghouses. So that was the issue.

In terms of the prefunding, I think the points were both that it should be prefunded and held in escrow so that it's available.

MR. CUTINHO: Well, let me point to those two things. First is historically, if you look at it, any clearing member that has failed has failed to multiple CCPs, generally speaking. If you look at a large clearing member failure that has happened. And that is taken into account because there is no netting, so there is collateralization at each CCP for the exposures at each CCP, there is no netting going on between the two. So that's something to keep in mind.

So the second thing is prefunding. So the way to think about it is what problem are we solving with prefunding of assessments? So if the issue is you want greater protection, having something in escrow is not going to give you greater protection. So take, for example, a large -- so the size -- the sizing of a fund is based on the simultaneous failure of the two largest net debtors who have losses in excess of their margin. Yeah? And then the issue is when they fail, they won't be there to give assessments. That's what assessments are. They are sized taking into account that those two don't exist. But if you're saying prefunding, right, rather than everybody prefunding, if the issue or the problem you're trying to solve is assessments won't be available from the failed entities who are bringing the largest risk, then it's better to prefund. If the suggestion is prefunding, it's better to prefund in the waterfall. Of course, it can be used in the right order, but it's suggested in the waterfall. Because if you look at the loss absorbing chain, it's margin, then guarantee fund. So even if you touch the mutualized pool, if you have more capital there, which is a function of some risk -- maybe concentration, maybe size, size of the business -- we are not suggesting, by the way, that this is what we need right now. In our opinion, assessments are very credible. If you -- if you go back, if you look at the assessments as a size of the firm's capital, that's one measure. If you look at assessments as a size of the typical variation margin that a clearing member has to pay during times of stress, they are fractions. Assessments are actually fractions of that.

Having said that, there is also another provision, especially in our rules. If the markets move in a manner so that the defaulter's margin is insufficient to some threshold level, assessments can be precalled even before you exhaust prefunded margin. So assessments I think are a very, very credible tool because lack of committing or paying an assessment is a failure, is a default. So I don't -- I challenge the idea that assessments are not a credible tool.

MS. WALTERS: You know, I think, Sunil, what we're simply saying is that --

CHAIRMAN MASSAD: Can I -- excuse me. I'm sorry to interrupt. I just have to leave. As important as this discussion is, I've got to go attend the Financial Stability Oversight Council Meeting, another systemic risk discussion. But I just want to thank Susan and Gerald for moderating. I want to thank Kristen and Angela and Bill for your presentations. I want to thank all of you for participating, particularly representatives of the clearinghouses. This has been an incredibly useful discussion. I'm sorry I have to cut out a little bit early, but I look forward to getting a full briefing on what else is said. And this work will continue, obviously, not just through MRAC but through all the other ways that we are discussing this issue, both within the Commission and internationally as well. So thank you all again.

MS. WALTERS: Sorry. I think what we would say is just in general we feel that the loss absorbing capacity, including all sources of funding are currently insufficient to handle, you know, single or multiple clearing member defaults, and assessments are a good tool, and we recognize actually that they would flow through to the cost of clearing for our clients. But you have to do them in peacetime, not wartime. So if you hold off and don't have the assessments done until wartime, then you're unable to actually -- you're unable to actually make the assessments or obtain the cash that you need. That's the point that is should be prefunded.

MR. CUTINHO: Let me challenge the first one. Why do you think the loss of job incapacity is insufficient? I just heard margin plus guarantee fund plus CCP contribution plus the mutualized pool. The whole size is insufficient to cover one default.

MR. THUM: I think, I mean, I could jump in a little bit. I think there's a couple issues. You know, one is the issue of overall adequacy and the other is setting standards.

MR. CUTINHO: Okay.

MR. THUM: I think that with respect to the clearinghouses that Vanguard uses, I think we have great confidence in our clearinghouses.

MR. CUTINHO: Okay.

MR. THUM: We also have a fair window in to the information that comes with respect to their financial resiliency. That being said, I think what we're looking for is for the regulator to establish a minimum standard for these different areas so that the reporting can be transparent across all market participants. And some of the reason why we're raising these issues about enhancing the standardization, enhancing the level of transparency is because there are discussions about haircutting and margin. And that is of great concern to us, even with the window in and the great relationship that we have with our clearinghouses. You know, we're not presently concerned about our margin. We're not presently concerned about the clearinghouses. But we think that particularly as that topic has come it, it really underlines the need for consistent standards and transparency. And we think that the clearinghouses that we use will not only have performed but will demonstrate superior performance against those standards and the transparency.

I would say as well there's a relationship between the level of transparency into what the CCP is doing and the level of capital commitment that needs to be put aside to support the operations. Certainly, I think Vanguard is saying the more transparency is provided, probably the lower the capital commitment needs to be. In the absence of the transparency, it is hard to even assess what amount needs to be set aside in the absence of transparency. So I think more transparency, less capital, but clearly standards across the board and reporting across those standards.

MR. CUTINHO: Let me address your point on margin haircuts. We are with you. So if you look at the current rules, they call for actually closing our positions and giving you back money. Because if we are talking about a circumstance where the markets have broken down, you know, and a lot of members have failed, there is chaos in the financial markets, right, reasonably? It's, you know, it's not the cleared markets that, you know, if you look typically in financial crisis, of course the future ones may be different. But at the end of the day, if you consider the scenario where a lot of members have failed, we would rather prefer to give you back your money. Certainty is about giving you back money and closing out positions so there is no further risk. So we are with you there. We don't think margin haircuts is a good approach. It will create a run. It will force clients to actually close out their positions.

MR. THUM: The margin will be there. Right, exactly.

MR. CUTINHO: Yes. But at the end of the day, I think what we're trying to do right now is, you know, there are several tools in the basket. One of them is partial haircut versus partial termination versus a full termination. Rather than closing all markets, if there is one market or a smaller market that has failed, rather than, you know, closing out the entire market, just close out -- localize the termination or the tear up to the markets that are broken rather than all the markets. Why create a crisis when there isn't one; right? So that's one.

The second thing is as far as gains haircutting, there are two things we talked about. One is gains haircutting and the other is margin haircuts. The role of gains haircutting is a very -- is a bad tool. But at the end of the day, the reason that gains haircutting is a tool there is to incent people to actually enter into and participate in auctions. At the end of the day, the issue there is you don't want somebody there sitting with gains to just be a holdout, and this is to solve for the holdout problem when the object is to actually auction off the book or the closeout and restore a matched book. So that's the purpose of gains haircutting and it cannot be done indefinitely. It's just a limited purpose tool for a very small set of circumstances to act as an incentive.

MR. LEWIS: One of the differences in practice in the U.S. versus Europe is in Europe for futures, triparty custody is allowed for, you know, and my only point is that in the Eurex model where the option is provided not only for triparty custody of the margin money but also of full customer segregation which ensures that the client margin funding is not at risk. Now, the nice thing about that approach is that it costs more but the cost is absorbed by the -- that's not a nice part about it, but it's -- at least for a different model the cost is borne as was suggested willingly for the additional protection, and I just would urge particularly given the continuing ambiguity about U.S. Bankruptcy protections against clawbacks in the event of a FCM default, that you guys should be looking more at tools that do work effectively elsewhere that would provide a much greater certainty of protection and that could be dropped into the current system. As I say, because we deal with, as you're suggesting, windows and orphans, you know, national pension funds in Europe who have these same concerns, and the structure is really designed to prevent this from coming up. I don't know. There's controversy about importing that approach to the U.S., but at least it would be relatively actionable I think because I think the CFTC would have within its gift, in fact, the ability to fix that problem. There are those that disapprove of this at the Commission for good reasons, but the question is if it's a choice and you guys feel like it would work to protect you, I would just think that that might be something to consider.

MR. CUTINHO: Cliff, I'd like to challenge you there. Actually, I don't think segregation would protect you in this circumstance that the team is talking about. In Europe there is under -- I mean, that is under consideration. The rules are not out. For margin haircuts, for nondefaulting clients, it doesn't matter whether they're segregated or not. So they will be subject to it when they reach here in the U.S. We have taken a stand. We have said margins are sacrosanct. You cannot touch it. It's only gains haircutting. So segregation, in and of itself, doesn't help. Of course, you know, if CCP considers it, it may end up haircutting everybody's margin. So, it's not about -- the segregation only prevents losses from one client affecting another client for failed firms.

L: Good point.

MR. THUM: One other point I wanted to build on, what Sunil said earlier, just as I said, I think there's an interrelationship between transparency and the capital contribution. I think there's also an interrelationship between what we're talking about and the standards and guidelines for mandating a particular product to be cleared. And I think that not only do those standards need to be assessed against this risk discussion and the risk that mandating a product to be cleared introduces into the system, but I think it also needs to be refreshed regularly to make sure that the liquidity levels are what they need to be, the product is standardized, that there are multiple clearinghouses that can clear the product, that those clearinghouses have, you know, effectively a threshold number of clearing members that are providing liquidity within them. I think there's a lot of interrelated issues, so it's hard to talk about any one of them in isolation and make a compelling argument given the interrelationship between all of them. So I know that certainly the CFTC is focused on these issues, but I think it's important to lay it out here. You know, we're mostly talking about products that are mandated to be cleared, and the stresses I think that it puts on risk management back at our house is we were very, very supportive of the clearing mandate. As I said, Vanguard clears I think just about all of its swaps at this point, both on the interest rate side and CDX, but that being said, as we look at issues, particularly in the context of folk talking about haircuts on margin, you know, we want to see not only recommended best practices, we want to see not only strong, robust practices of our clearinghouses that we currently deal with, but a standardized threshold of behavior that can be looked at across all clearinghouses, where stress testing can be applied and the risk management back at our shops can see how the different clearinghouses are performing against those same standards and making a decision to continue clearing. We fully expect the clearinghouses that we use will shine in that examination. But we think it's important that that be one component, there be minimum standards set stress testing against that, independently verifiable, and transparent to all market participants.

MR. BEESON: All right. Being mindful of the time, we've got a few other comments on the table here that we'll move forward with.

Andrew, you have a comment?

MR. GRAY: Yeah. I'll be very quick because we don't really have time for a point-by-point discussion on each of the items you've raised, but thank you for sharing your views.

I did want to point out that there are some differences with respect to how DTCC operates. Our ownership structure is different. As I said before, we are member-owned. We trade cash instruments. And so we look at these recommendations a bit differently. And I would refer everyone to a paper that we produced a couple months ago on CCP resources and resiliency where we laid out our views that are specific to how DTCC operates on many of the topics that have been discussed here. Thank you.

MR. BEESON: Richard?

MR. MILLER: Thank you, Gerald. Just briefly, because insurance companies like Prudential and others are directional players in the market, I want to endorse your comments. I think they're right on point, and we, too, would like to see greater transparency and more consistency across the stress testing so that we can underwrite our risks like we would in the customary over-the-counter market. We'd like to do the same with respect to CCPs where we're compelled to conduct our clearing business. We, too, hope and expect everything will shine when we look under the hood, but at this point in time our hands are basically tied. We can't really do it for ourselves. We need more help.

MR. BEESON: Kevin?

MR. MCCLEAR: Just real quickly, because like Andrew said, I don't think it's possible in a short time period to address all the points that were raised in your good letters. But I would like to end on a good note. I think we all agree clearing is fundamentally good. It's the foundation of the EMIR and Dodd-Frank. It's disciplined. It's very transparent. It's becoming more transparent. We'll work with you in that respect.

The one point I did want to respectfully challenge though is this notion that a clearinghouse's contribution to the default waterfall should be risk-based. I think, respectfully, that's fundamentally flawed because clearinghouses are central counterparties. We don't take on positions. We don't take on position risk. We manage the risk and that's why ICE agreed voluntarily to contribute to the default waterfall. But we did it for commercial reasons, to align our risk management practices with our clearing members and their customers. I think it's very dangerous to impose a risk-based requirement on the clearinghouse because it potentially disincents those behind us in the waterfall to manage that risk. A good example of that, too, is when we get to a default auction, we require our clearing participants to bid on the defaulting portfolio. But if they see that the clearinghouse has a big chunk of capital in front of that, they're going to factor that bid, that amount of capital into their bid and effectively lessen the bid. So I think we need to be more thoughtful and careful when we talk about a risk-based methodology.

Thank you.

MR. THUM: I think the only point I would say to that is that, you know, we see the contribution to really be the discipline that effectively applies to the CCP's performance of its role. So while we certainly look to the CFTC's oversight of the clearinghouses, it's the clearinghouses that are on a day-to-day basis assessing the positions that are coming in, that are making assessments with respect to the FCMs, are doing the margin calculations, are, you know, insisting that it all performs in accordance with its ruleset. And right now we have great confidence that they will do that. But having effectively an adequate level of skin in the game effectively is an incentive to make sure that that happens on a consistent basis forever.

MR. CUTINHO: Two comments though. One is I know -- I didn't want to skip the discussion about for-profit versus not-for-profit. I'd like to -- I know we have spoken a lot on this, but I'd like to challenge you to show as an example where for-profit CCPs are weaker in terms of their risk management versus not-for-profit. So take any measure and challenge us. And I think that's something that we'd like to work with you on. It'll be a fun exercise for us.

The CCP contribution -- actually, I'll take a slightly different explanation than what Kevin did because we do look at it from a risk perspective. It is actually risk-based. And it's the risk that we bring. Right? And the important thing for us -- let me just bring this incentive effect. Okay? We are talking about CCP capital contribution to cover the default of a participant. There are other risks in the system where a CCP uses its capital to cover. Right?

So-called "skin in the game." So let's go over these. Right?

So when it is clearing member failure, you want to make it a "defaulter pays" model. Anything other than that will result in subsidization. So that's something to think of. So let's start from the problem we're addressing and then let's look for a solution. So in order to make a default or pays model, you cannot have the defaulters -- the risk that a default brings be subsidized. Right? So that is something that Kevin pointed out. So it is risk based. We have to make sure the incentive effect is that the defaulter continues to pay. So you cannot subsidize a defaulter pays more.

But let's look at the operational risk and investment risk. Those are risks that a CCP takes. Of course, a CCP should stand and take 100 percent of that, should not neutralize it. Risk within their control; right? So the risk within their control, the risk that they bring, they should actually bear those risks. So it is risk based. The CCP contribution should be risk based. So we are with you. It's essentially the risk that you think and we think may be different. So I just want to have that conversation, that open dialogue.

MR. THUM: That gets at you performing your obligations and your responsibilities under the rule set in a full and robust fashion on a daily basis. So I think, you know, we're in agreement that that is a major focus.

MR. BEESON: Sorry, go ahead.

MS. PORTNEY: Just two comments. We at JPMorgan, along with many other clearing members have been pretty vocal around the fact that CCPs themselves do -- can and do make risk decisions day in and day out. They decide membership requirements. They decide what products to clear. They alone decide margin. They decide what is acceptable collateral. They decide what haircuts to apply to that collateral. Every single one of those decisions they make, they have the power to make and they do make, and any one of those can, and does, introduce risk to the system. And there are many instances where clearing members have gone on record for each one of those disagreeing with what a clearinghouse has ultimately decided to do in terms of, for example, new products, et cetera, which, unfortunately, you know, ultimately, the for-profit incentive to grow the revenues has really prevailed. So I would say that's just one thing.

The only other thing I would just say just as a matter of observation, and I do think they representatives from the buy side have been very, very eloquent here and it's frankly better to hear from you than it is probably to hear from the sell side. But one thing I would just ask is at the end of the day, clearinghouses have many, you know, have many customers, but their clearing members are a customer and all of the end-users are a customer. You are hearing in a very -- a real loud consensus that at the end of the day, your end customers and your users feel that you should have more skin in the game, more disclosure, and there should be, you know, some form of more oversight and consistency in stress testing. Generally speaking, I would think that an industry actually would want to respond to their customer base and their end-users.

MR. BEESON: Ed, you had a tent up earlier.

MR. PLA: Just maybe an echo of your comment on stress testing. I think we need to remember that stress tests should be hard and, you know, again, I think the unison with which you speak about these issues is refreshing to hear because I think we should be holding ourselves to high standards. But we have to remember that stress tests by their nature are plausible but incredibly unlikely, which means they should be hard tests to meet and they should be transparent. It shouldn't be, you know, they shouldn't be rules based specific to CCPs, we don't believe. We believe that they're scoped to standardize these and make these far more transparent, much easier to understand, and then we can all assess for ourselves whether or not stress tests have truly set a very high bar for the industry at large and make them easy to compare.

MS. WALTERS: I would just add that I think, you know, again, post-financial crisis, stress testing that's been -- that was implemented and has been conducted on commercial and investment banks in a standardized way overseen by regulators has demonstrated that something that's very difficult can be done. It can be crafted and nuanced and fine-tuned based on changing market conditions. And to be honest, it puzzles me why an approach that, you know, has been battle tested and can be done, why we would think of trying to apply something else. I mean, certainly, fine tuning it so it applies to central clearing makes sense, but I can't in my 25 years of, you know, kind of risk management, think of a reason why we wouldn't want to follow a standard that has actually worked well.

MR. BEESON: Sorry. Any other comments? Thank you.

MS. WALKER: Thank you, Gerald, for leading the panel, and thank you so much for your leadership with the writing, along with your staff, including Steven Berger on these recommendations.

I will now turn to Mr. Tom Kloet who is here from Elmhurst College but has a long history in these markets to close us out.

MR. KLOET: Thank you, Petal. And yes, Commissioner Bowen asked me to close the meeting out. So first, I want to thank her for her continued sponsorship, and Chairman Massad for his active participation today. Having them with us obviously helped the discussion significantly.

I'd also like to join in thanking Susan O'Flynn and her team for the great work on the recommendations. They were well thought through and very clear. I think we had an excellent discussion and a number of areas where we had real consensus. So congratulations, Susan, to you and your team for putting that together.

But mostly, I think we did exactly what

the MRAC is supposed to do, and that's give the Commission feedback -- ideas and feedback on these important risk issues. That's why we're here. We had an excellent discussion on items one and two. Items three, four, and five are also within the view of the CCP Coordination Subgroup and they'll be part of our discussion during the New Year. And then finally, like Petal, I'd like to thank the three representatives -- both Gerald and the three participants from the buy side. Your input is very valuable to this process, and we thank you for your very direct input and clear messaging with respect to your views.

So with that, I'll turn it back over to you, Petal.

MS. WALKER: The meeting is now closed. Thank you.

(Whereupon, at 1:31 p.m., the PROCEEDINGS were adjourned.)

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

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