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COMMODITY FUTURES TRADING COMMISSION

OPEN MEETING OF THE COMMISSION

Washington, D.C.

Thursday, September 8, 2016

PARTICIPANTS:

Commissioners:

CHAIRMAN TIMOTHY G. MASSAD

COMMISSIONER SHARON Y. BOWEN

COMMISSIONER J. CHRISTOPHER GIANCARLO

CFTC Staff:

CHRISTOPHER KIRKPATRICK
Secretary of the Commission

Staff Presentation: Final Rule - System Safeguards Testing Requirements

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Staff Presentation: Final Rule - System Safeguards Testing Requirements for Derivatives Clearing Organizations

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Division of Clearing and Risk

PARTICIPANTS (CONT'D):

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Division of Clearing and Risk

Staff Presentation: Comparability Determination for Japan Uncleared Swap Margin Rules for Substituted Compliance Purposes

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P R O C E E D I N G S

(10:06 a.m.)

CHAIRMAN MASSAD: Okay, good morning. This meeting will come to order. It's after Labor Day, the kids are back in school, so we thought we'd kick off the fall with an open meeting this morning. This is a public meeting of the Commodity Futures Trading Commission. I'd like to welcome members of the public, market participants, and members of the media, as well as those taking part on the phone or via webcast.

Today we gather to consider three important measures. The first two are final rules that will enhance cybersecurity and operational safeguards in our markets. In addition, we will consider a determination of comparability with respect to Japan's margin requirements for uncleared swaps.

The risk of cyberattack probably represents the single greatest threat to the stability and integrity of our markets today. Instances of cyberattacks are all too familiar

both inside and outside the financial sector. Today they are often motivated not just by those with a desire for profit but by those with a desire deliberately to disrupt or to destabilize orderly operations. And that is why the system safeguard rules are so important. They will apply to the core infrastructure in our markets, the exchanges, clearing houses, trading platforms, and trade repositories. They will ensure that those private companies are adequately evaluating cyber risks and testing their cybersecurity and operational risk defenses. And while our rules already require this generally, the measures we will consider today add greater definition, not by being overly prescriptive, but by setting some principles-based standards rooted in industry best practices.

I've said many times that as regulators we must not just look backwards to address the causes of past failures or crises. We must also look ahead, ahead to the new opportunities and challenges facing our markets. Financial markets

constantly evolve, and we must ensure our regulatory framework is adapting to those changes. These rules are one good example of how we are looking ahead and addressing these new challenges.

I want to thank all those who provided feedback on the proposed rules the Commission approved last December. We received a number of thoughtful comments from market participants, most of which expressed broad support for the proposals. Commenters also highlighted some areas of concern; and as you will hear, we've made adjustments based on that feedback.

For example, we have reduced the frequency of controls testing and narrowed the instances where independent contractor testing is required. We have also clarified definitions of key terms and made clear that the scope of required testing will be based on appropriate risk and threat analysis.

If approved, these new rules will serve as a strong and important complement to the many other steps being taken by regulators and market

participants to address cybersecurity. For example, government agencies and market participants are already working together to share information about potential threats and risks and learn from one another.

Today we will also consider a measure that will further our commitment to international cooperation and harmonization: The comparability determination with respect to Japan's rules on margin for uncleared swaps. This will provide that a Japanese swap dealer registered with the CFTC can comply with many aspects of our margin rules by meeting Japan's corresponding requirements. Comparability determinations like this are critical to building a strong and sensible international regulatory framework.

As always, let me thank the hardworking CFTC staff for their work on today's rules and for what I'm sure will be instructive presentations. And I also want to thank my fellow Commissioners -- Commissioner Bowen and Commissioner Giancarlo -- for their commitment to these issues and their

involvement. Let me first recognize Commissioner Bowen for any opening remarks.

COMMISSIONER BOWEN: Thank you, and good morning. I will be voting yes on both of these system safeguards rules today. There's really not much more to say than I said about these rules when they were proposed in December 2015. Cybersecurity is a top concern for American companies, especially financial firms. These rules are a good step forward in addressing those concerns. I want to thank the staff for their hard work on this, and I'd like to give my remarks later on the other rules.

CHAIRMAN MASSAD: Commissioner Giancarlo.

COMMISSIONER GIANCARLO: Thank you. This morning I issued two written statements concerning the rulemakings before the Commission. Thus, my oral remarks will be brief.

As for system safeguards, I and my fellow Commissioners are united in the recognition that cyber and system security is of the utmost

importance to the integrity and durability of financial markets. When I voted in favor of these rule proposals last December, I said they were a constructive step in better defending markets and participants from cyberattack.

I believe that the final rules before us are better balanced than the original proposals. They provide greater flexibility to market operators, and they address my concern that simply being hacked cannot be considered a rule violation subject to enforcement and that market operators should not be held strictly liable for cyber breaches.

I commend CFTC staff for their good work and often thoughtful responses to the commentators. I draw their attention to my written statement that does raise some concerns about some costs in the rule that will be imposed on smaller DCOs and offer some practical suggestions.

As for the comparability determination for Japan, I harken back to my dissent to the rule

on cross-border application of margin requirements for uncleared swaps. I said then that the comparability framework was overly complex and unduly narrow. I said the element-by-element methodology for permitting substituted compliance was contrary to the principles-based holistic analysis that the Commission has used in the past. And I said that it could result in an impractical patchwork of U.S. and foreign regulations for cross-border transactions. I worried that it would make it harder for American financial firms to serve their customers around the world.

Last Wednesday, I warned of a liquidity crunch that could occur if the CFTC and U.S. bank regulators barreled ahead with the September 1 implementation of cross-border margin despite the delay of the rule by 21 out of 24 overseas regulators. I said imposing the rule would put U.S. industrial and other companies needing to hedge risks using uncleared swaps at a competitive disadvantage to their overseas competitors. I advised instead that U.S. Regulators announce an

immediate pause long enough to reach a new agreement with their overseas counterparts on a final deadline for joint implementation. My advice went unheeded.

Sure enough, one day later, Asian swaps markets almost ground to a halt amid chaos and confusion over the application of the new margin rules. I received reports of counterparties avoiding trading with U.S. persons. Many trades were rejected.

This disruption was totally avoidable had the CFTC and its fellow U.S. regulators been less concerned with sticking to an arbitrary deadline and more concerned with the impact of a self-induced market shock on the welfare of American business.

I take the opportunity now to reiterate my warning that the cross-border margin rule's subjectivity and complexity will continue to be a source of regulatory uncertainty at the expense of U.S. financial firms, their employees, and the American businesses that they serve.

But turning to the issue before us, despite an analytical process that is overly complex and unduly narrow, the determination does appropriately recognize that certain differences between the U.S. and Japanese margin regimes achieve comparable outcomes. Wrong approach, right result. Therefore, I will support the determination.

Thank you.

CHAIRMAN MASSAD: For each of the items on today's agenda, the staff will make presentations to the Commission. After each presentation, the floor will be open for questions and comments from each of the Commissioners. Following the close of discussion on each matter, the Commission expects to vote on the staff recommendation as presented. All final votes conducted in this public meeting shall be recorded votes. The results of votes approving the issuance of rulemaking documents will be included with those documents in the Federal Register. At this point, I ask unanimous consent to allow staff

to make technical corrections to the documents voted on today, assuming they are approved, prior to sending them to the Federal Register.

Without objection, so ordered. At this time, I would like to welcome the following staff for their presentations on two rules related to system safeguards. First, from the Division of Market Oversight to my right, Vince McGonagle, the director; Rachel Berdansky, deputy director; Susan Stewart, systems risk analyst; David Steinberg, associate director; and David Taylor, associate director. And from the Division of Clearing and Risk, Julie Mohr, deputy director; James Ortlieb, associate director; and Eileen Donovan, deputy director.

I will now allow the staff to make their presentations, so I will turn to DMO, and I think Susan and David will make the presentations.

Okay, thank you.

MR. MCGONAGLE: Yes. Thanks, Chairman.

MR. TAYLOR: Good morning, Mr. Chairman and Commissioners.

Before I begin, I would like to thank my fellow Division of Market Oversight team members, including Rachel Berdansky, David Steinberg, Shifra Katz, Susan Stewart, Chris Russell-Wood, Michael Bartlett, and Kyle Miller, and my system safeguards colleagues in the Division of Clearing and Risk, as well as Dave Reiffen from the Office of the Chief Economist and Dhaval Patel and Susan Nathan from the Office of the General Counsel for their hard work in preparing the final rules that we are presenting to the Commission today.

Today, staff is recommending that the Commission approve two parallel final rulemakings addressing cybersecurity and system safeguards requirements for designated contract markets, or DCMs; swap execution facilities, or S-E-Fs or SEFs; swap data repositories, or SDRs; and derivatives clearing organizations, or DCOs. My DCR colleague, Julie Mohr, and I will share the task of making the presentation.

The final rules would enhance and clarify existing Commission rule provisions

related to cybersecurity testing and system safeguards risk analysis and oversight, and add new provisions concerning certain aspects of cybersecurity testing. Most importantly, the final rules would clarify the existing rules by specifying and defining the types of cybersecurity testing that DCMs, SEFs, SDRs, and DCOs must conduct in order to fulfill their regulatory system safeguards testing obligations.

Cybersecurity testing by DCMs, SEFs, SDRs, and DCOs can harden their cyber defenses, mitigate their operations reputation and financial risk, and maintain and increase their cyber resilience and their ability to detect, contain, respond to, and recover from cyberattack. As set out in detail in both rulemakings, cybersecurity testing is a well-established best practice both generally and for financial sector entities.

As we will outline for you, the central point of the final rules would be the requirement for all DCOs, all DCMs, all SEFs, and all SDRs regulated by the Commission to conduct five

important types of cybersecurity testing that are essential to an effective program of system safeguards risk analysis and oversight: One, vulnerability testing; two, penetration testing; three, controls testing; four, security incident response plan testing; and five, enterprise technology risk assessment.

The Commission's existing system safeguards rules require these entities to conduct testing to ensure the reliability, security, and capacity of their systems. Best practices establish that it would be impossible to fulfill the purposes of that requirement without conducting these five types of testing. In this respect, therefore, the final rules would clarify what is already required of these entities.

As we will note in presenting each of the five types of testing, the final rules would also establish minimum testing frequency and independent contractor testing requirements for all DCOs and all SDRs and for covered DCMs. These requirements are also generally consonant with

best practices. As defined, covered DCMs would be those whose total annual trading volume is 5 percent or more of the total annual trading volume of all DCMs regulated by the Commission.

The proposed rule for DCMs, SEFs, and SDRs included an Advance Notice of Proposed Rulemaking, or ANPRM, which noted that the Commission plans to consider whether in a future Notice of Proposed Rulemaking, or NPRM, it should define the most systemically important SEFs as covered SEFs and make them subject to the minimum testing frequency and independent contractor testing requirements. In the ANPRM, the Commission noted that the SEF market is still in the early stages of development. The Commission received several comments concerning the ANPRM.

Staff recommends that further consideration and consultation with both the industry and other relevant regulators and stakeholders would be appropriate and helpful before issuance of any future NPRM regarding covered SEFs. Accordingly, staff plans to hold a

public roundtable later this fall regarding SEFs, to gather additional information that will assist the Commission in determining whether to issue a future NPRM regarding covered SEFs.

MS. MOHR: As I begin the next section of our presentation, I would also like to thank my fellow DCR team members, including Jim Ortlieb, Tammy Roust, Eileen Donovan, Tad Polley, and Scott Sloan, as well as Carlene Kim and Brian Trackman of OGC for their hard work in preparing the final rules that we are presenting to the Commission today. We will briefly describe for you this morning each of the five types of cybersecurity testing that would be required by the final rules, beginning with vulnerability testing.

Vulnerability testing is the process of scanning your systems for weaknesses. As software is developed and deployed, new weaknesses called "vulnerabilities" can be created for various reasons. For example, adding new features to existing software generates transaction paths and logic that creates future opportunities for

unwanted users to exploit these features in unintended ways.

Moving software or hardware around within existing environments can create interconnections between systems and paths through existing systems that offer fresh opportunities for intruders to enter and exploit. In addition, existing software is constantly being tested and probed in ways by existing deployments, including both research efforts and real-world attacks. As a DCM, SEF, SDR, or DCO deploys, modifies, and runs its systems, it must remain cognizant of the fact that external entities are constantly probing its defenses looking for these vulnerabilities. If the organization can discover its vulnerabilities before the attackers do, it can attempt to fix them before they are exploited.

Vulnerability testing is covered by generally accepted standards and best practices, such as those published in the National Institute of Standards and Technology, or NIST, and the Federal Financial Institution Examinations

Council, or FFIEC, and others. Such generally accepted best practices call for vulnerability testing at a frequency determined by an appropriate risk analysis and in some cases also provide that the frequency for such testing should be no less than quarterly.

The final rules would address the frequency at which vulnerability testing should be conducted. As a fundamental principle, we would call for all DCMs, SEFs, SDRs, and DCOs to conduct vulnerability testing at a frequency determined by an appropriate risk analysis. For all DCOs, all SDRs, and covered DCMs the rule would also include a minimum vulnerability testing frequency requirement calling for testing to be conducted no less than quarterly. In addition, the final rules would call for vulnerability testing by all DCOs, all SDRs, and covered DCMs to be performed by independent contractors or employees who are not responsible for the development or operation of the systems or capabilities being tested.

In the NPRM, the Commission proposed

requiring all DCOs, all SDRs, and covered DCMs to engage an independent contractor to conduct two of their required quarterly vulnerability tests each year. Commenters noted the potential security risks, as well as the cost, of hiring an independent contractor to conduct the vulnerability testing. Therefore, the final rule will require all DCOs, all SDRs, and covered DCMs to engage an independent contractor or employees who are not responsible for the development or operation of the systems or capabilities of the systems being tested to conduct the required vulnerability tests.

The second type of cybersecurity testing that the final rules would require is penetration testing. Penetration testing is the process of simulating an attack on a system in order to discover and exploit its weaknesses.

There are two main forms of penetration testing: External and internal. The final rules would define external penetration testing as attempts to penetrate the entity's automated

systems from outside the systems' boundaries to identify and exploit vulnerabilities. The final rules would define internal penetration testing as attempts to penetrate the entity's automated systems from inside the systems' boundaries for the same purpose. Generally accepted practices such as NIST standards, FFIEC standards, and the Payment Card Industry Data Security Standards call for organizations to conduct both internal and external penetration testing and to conduct such tests annually.

The final rules would also call for all DCOs, DCMs, SEFs, and SDRs to conduct both internal and external penetration testing at a frequency determined by an appropriate risk analysis. In addition, the rules would require internal and external penetration testing at least annually by all DCOs, all SDRs, and covered DCMs.

The final rules would also provide that the annual external penetration test required of all DCOs, all SDRs, and covered DCMs must be performed by an external independent contractor.

MR. TAYLOR: The final rules would also call for all DCMs, SEFs, SDRs, and DCOs to conduct controls testing, including testing of each control included in their programs of systems safeguards risk analysis and oversight. Controls are the safeguards or countermeasures used by an entity to protect the reliability, security, or capacity of its automated systems or the confidentiality, integrity, and availability of its data and information. Some controls provide safeguards against automated system failures or deficiencies while others guard against human error deficiencies or malicious action. Controls testing assesses each control to determine whether it is implemented correctly, is operating as intended, and is enabling the organization to meet system safeguards requirements. Such testing is called for by generally accepted best practices and standards.

The final rules would address the frequency at which controls testing should be conducted. As a fundamental principle, they would

call for all DCMs, SEFs, SDRs, and DCOs to conduct controls testing at a frequency determined by an appropriate risk analysis. For all DCOs, all SDRs, and covered DCMs, the rules would also include a minimum controls testing frequency requirement calling for testing of each key control no less frequently than every three years.

Key controls are those controls that a risk analysis determines to be either critically important for effective systems safeguards or intended to address risks that evolve or change more frequently, and therefore require more frequent review to ensure continuing control effectiveness. Since systems safeguards involve large numbers of controls, the final rules would permit the controls testing to be done on a rolling basis over the course of the required period.

In the NPRM, the Commission proposed a minimum testing frequency of no less frequently than every two years for all controls. Based on the comments received, staff believes that a

three-year rather than two-year minimum controls testing frequency requirement for the key controls is appropriate. Staff further agrees with commenters that registered entities should determine the testing frequency for non-key controls based on appropriate risk analysis. Therefore, the final rules would require registered entities to test each control at a frequency determined by an appropriate risk analysis and each key control no less frequently than every three years.

The final rules would also call for all DCOs, all SDRs, and covered DCMs to have independent contractors test each of the registered entities' key controls no less frequently than every three years. Such independent assessments are consonant with best practices.

The fourth type of testing that the final rules would require is security incident response plan testing. Best practices call for financial sector entities to maintain and test a

security incident response plan, or S-I-R-P, doubtless to be pronounced SERP. Such plans are crucial to cyber resilience.

The final rules would require each DCM, SEF, SDR, or DCO to maintain and test a SIRP, defined as a written plan documenting the entities' policies, controls, procedures, and resources for identifying, responding to, mitigating, and recovering from security incidents and the roles and responsibilities of its management, staff, and independent contractors in responding to security incidents. The rules would note that SIRP testing can take a number of possible forms from checklists and tabletop exercises to simulations and comprehensive exercises.

The final rules would also address the frequency at which SIRP testing should be conducted. As a fundamental principle, they would call for all DCMs, SEFs, SDRs, and DCOs to conduct SIRP testing at a frequency determined by an appropriate risk analysis. At a minimum, the

final rules would call for all DCOs, all SDRs, and covered DCMs to have SIRP testing performed no less frequently than annually. SIRP testing could be done either by independent contractors or employees of the entity.

The proposed rules called for SIRP testing to be conducted by either independent contractors or employees who are not responsible for development or operation of the systems or capabilities tests. Based on a comment, staff believes that allowing the employees who designed a SIRP to test the plan could provide useful benefits and flexibility to all DCOs, DCMs, SEFs, and SDRs without impairing the purposes of the CEA and Commission's regulations. Therefore, the final rules would require SIRP testing to be conducted by either independent contractors or employees without restricting which employees may lead or conduct the testing.

Finally, the final rules would require each DCM, SEF, SDR, or DCO to conduct enterprise technology risk assessments, or ETRAs.

An ETRA is a written assessment including identification and analysis of threats and vulnerabilities and the harm they could cause, in the context of mitigating controls. In an ETRA, a DCM, SEF, SDR, or DCO may draw together and use the results of the other types of cybersecurity testing in order to identify and mitigate its cybersecurity risks. Conducting ETRAs is consistent with best practices regarding system safeguards. As a fundamental principle, the final rules would call for all DCMs, SEFs, SDRs, and DCOs to conduct an ETRA as often as indicated by appropriate risk analysis.

At a minimum, the final rules would require DCOs, covered DCMs, and SDRs to have ETRAs performed no less frequently than annually. The ETRAs may be conducted using either independent contractors or employees not responsible for development or operation of the systems or capabilities being assessed.

MS. MOHR: The Commission's current regulations specify various elements, standards,

and resources to be included in a registered entity's program of risk analysis and oversight with respect to its operations and its automated systems. The final rules would clarify the existing rule provisions for all DCOs, DCMs, SEFs, and SDRs concerning (1) the categories of risk analysis and oversight that must be addressed; (2) the books and records obligations; (3) the scope of system safeguards testing; (4) internal reporting and review of testing results; and (5) remediation of vulnerabilities and deficiencies disclosed by testing.

The final rule provision that would address the required scope of cybersecurity testing is especially important, because adequate testing depends on identification of an appropriate scope. The final rules would require that the scope of all testing assessments required by Commission regulations be broad enough to include the testing of automated systems and controls that a registered entity's required program of risk analysis and oversight and its

current cybersecurity threat analysis indicate is necessary in order to identify risks and vulnerabilities that could enable an intruder or an unauthorized user or insider to (a) interfere with the registered entity's operations or with fulfillment of its statutory and regulatory responsibilities; (b) impair or degrade the reliability, security, or capacity of a registered entity's automated systems; (c) add to, delete, modify, exfiltrate, or compromise the integrity of any data related to the registered entity's regulated activities; or (d) undertake any unauthorized action affecting the registered entity's regulated activities or hardware or software used in connection with those activities. The NPRM required the scope of testing to be broad enough to include testing of all automated systems necessary to identify any vulnerability which could allow an unauthorized user access to the entity's systems. Based on the comments received, staff believes that a risk-based approach to determining the scope of testing is more

appropriate. Therefore, the final rules would base the scope of testing on a registered entity's program of risk analysis and oversight and its current cybersecurity threat analysis.

Another important clarifying provision relates to the governance of cybersecurity and system safeguards by requiring that the reports on the testing protocols and results be communicated to and reviewed by both the entity's senior management and its board of directors. Registered entities would also be required to establish and follow appropriate procedures for remediation of issues identified and for evaluation of the effectiveness of testing and assessment protocols. Each entity would be required to identify and document the vulnerabilities and deficiencies in its systems revealed by the testing and assessments required by the section. Each entity would also be required to conduct and document an appropriate analysis of the risks presented by such vulnerabilities and deficiencies to determine and document whether to remediate or accept each

risk.

In addition, the final rules would provide that required remediation must be timely with respect to the risk presented by the identified vulnerabilities and deficiencies. The NPRM required a registered entity to analyze the results of the required testing to identify all vulnerabilities in a system. Based on the comments, staff recommends removing a suggestion that all vulnerabilities will be revealed through testing.

The final rules would thus require a registered entity to identify and document those vulnerabilities that were revealed through the required testing. The NPRM also required entities to remediate the vulnerabilities to the extent necessary to enable the entity to fulfill the requirements of this chapter and meet its statutory and regulatory obligations.

Staff recognizes that some of the vulnerabilities may be properly accepted by the entity but believes that documentation is

necessary to ensure the entity is appropriately considering and responding to the risks.

The final rules would thus require a registered entity to conduct and document an appropriate analysis of the risk presented by such vulnerabilities and deficiencies to determine and document whether to remediate or accept each risk.

The divisions also recommend the final rules become effective after publication in the Federal Register but with a compliance date of 180 days after the effective date for vulnerability testing and security incident response plan testing and one year after the effective date for external penetration testing, internal penetration testing, controls testing, and enterprise technology risk assessment. The compliance dates were determined on a provision-by-provision basis to allow all DCOs, DCMs, SEFs, and SDRs -- regardless of their size, complexity, or resources -- to be able to meet the requirements of the final rules.

This concludes our joint presentation of

the final rules. We will be happy to address any questions.

CHAIRMAN MASSAD: Well, thank you to our staff for those excellent presentations.

To begin the Commission's discussion and consideration of these rulemakings, I will now entertain a motion to adopt the Division of Market Oversight's final rule - we'll take them one at a time - related to systems safeguards as presented by the staff. So, is there a motion to consider the DMO final rule?

COMMISSIONER BOWEN: So moved.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: All right, so I'd now like to open the floor to allow the Commissioners to make any statements and ask any questions they may have about them.

COMMISSIONER GIANCARLO: I have no questions.

CHAIRMAN MASSAD: Neither do I. Okay. So, let us then proceed to a vote. Let me just say for both presentations and for our staff, from

DMO and DCR, again thank you for the incredible amount of work that went into this. And also it's not just DMO and DCR staff that are here. There are obviously others in those divisions and others in other divisions - such as the Office of General Counsel, Office of the Chief Economist. As I have learned, there is an enormous amount of work that goes into this behind the scenes, and everyone involved in these rules is also doing a number of other things.

And, in particular, I want to thank the staff for listening to the input of market participants. I want to thank again market participants for giving us their input. I think it was very constructive. We did make a number of adjustments, as the staff has outlined, to make sure that these rules can work effectively.

So, with that, are we prepared to vote on the first rule? Okay, Mr. Kirkpatrick, will you call the roll.

MR. KIRKPATRICK: The motion now before the Commission is on the adoption of the Division

of Market Oversight Final Rule on System Safeguards Testing Requirements.

Commissioner Giancarlo.

COMMISSIONER GIANCARLO: Aye.

MR. KIRKPATRICK: Commissioner Giancarlo, aye. Commissioner Bowen.

COMMISSIONER BOWEN: Aye.

MR. KIRKPATRICK: Commissioner Bowen, aye. Chairman Massad.

CHAIRMAN MASSAD: Aye.

MR. KIRKPATRICK: Chairman Massad, aye. Mr. Chairman, on this matter the ayes have 3; the no's have zero.

CHAIRMAN MASSAD: Okay, thank you. At this point, I will now entertain a motion to adopt the Division of Clearing and Risk's Final Rule related to System Safeguards, as presented by the staff.

COMMISSIONER BOWEN: So moved.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: Okay, any questions or comments on that rule?

COMMISSIONER GIANCARLO: No questions.

CHAIRMAN MASSAD: All right, Mr. Kirkpatrick, could you call the roll.

MR. KIRKPATRICK: The motion now before the Commission is on the adoption of the Division of Clearing and Risk Final Rule on System Safeguards Testing Requirements for Derivatives Clearing Organizations.

Commissioner Giancarlo.

COMMISSIONER GIANCARLO: Aye.

MR. KIRKPATRICK: Commissioner Giancarlo, aye. Commissioner Bowen.

COMMISSIONER BOWEN: Aye.

MR. KIRKPATRICK: Commissioner Bowen, aye. Chairman Massad.

CHAIRMAN MASSAD: Aye.

MR. KIRKPATRICK: Chairman Massad, aye. Mr. Chairman, on this matter the ayes have 3; the no's have zero.

CHAIRMAN MASSAD: Okay, so the ayes have it, and the motion to adopt that final rule is approved as well. So, both rules are adopted.

Once again, thank you to the staff and to market participants for your input.

We will now have a shift in the seating and welcome the members of our staff from DSIO.

(Pause)

CHAIRMAN MASSAD: Okay, at this time I would like to welcome Frank Fisanich, deputy director, and Katherine Driscoll, associate chief counsel, from the Division of Swap Dealer and Intermediary Oversight for their presentation on a Comparability Determination for Japan's Uncleared Swap Margin Rules.

MR. FISANICH: Good morning. At the start, I'd like to thank my colleagues in DSIO and OGC and OIA for their valuable contributions to getting this done in a short amount of time.

Pursuant to the cross-border margin rule adopted by the Commission in May of this year and an application from the Japan Financial Services Agency, the JFSA, staff is presenting a recommendation that the Commission adopt a comparability determination for Japan with regard

to its margin requirements for uncleared swaps. Where the recommended determination has found the laws of Japan and the rules of the JFSA comparable to the Commission's uncleared swap margin rules, swap dealers who do not have a prudential regulator would be permitted to comply with the Commission's rules by complying with the JFSA's rules to the extent such substituted compliance is available under the Commission's cross-border margin rule.

Over the past three months, staff has consulted with the JFSA in the development of this determination. In addition, staff has consulted with the U.S. Prudential regulatory authorities, including the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. Staff notes that both Japan and the United States participated in the BCBS-IOSCO working group on margin requirements, and work undertaken by that group led to a broad international consensus on the substantive framework for global margin

requirements for uncleared swaps back in 2013. Both the CFTC and Japan promulgated margin rules meeting the principles of that framework, and such rules therefore have a very similar scope and objective.

The comparability determination staff is recommending today follows the standard of review mandated by the cross-border margin rule, which required the Commission to determine whether Japan's uncleared swap margin regime achieves outcomes comparable to those of the Commission's corresponding uncleared swap margin rules. Under the Commission's standard of review, a foreign margin regime must be comparable to the Commission's in purpose and effect but need not be identical or comparable in every aspect. The Commission also committed to evaluating outcomes in light of a foreign regulator's supervisory and enforcement authority. In other words, the Commission recognized that a foreign regime could achieve comparable outcomes through the exercise of supervisory authority.

The outcomes-based approach taken by this comparability determination is consistent with the approach taken by the Commission when it adopted the comparability determination for DCOs under E.U. law earlier this year and with the approach taken by the Commission in 2013 when it adopted eight comparability determinations for six jurisdictions with regard to certain other requirements under Part 23, including risk management program and recordkeeping requirements.

Adhering to the standard of review announced by the Commission, staff is recommending that the Commission find the laws of Japan comparable to the Commission's uncleared swap margin rules except in one area. Staff notes that with respect to many core requirements of the uncleared swap margin rules, the JFSA's rules are either essentially identical or substantially similar in all material respects. This includes required methodologies for calculating the amounts of margin, the process and standards for approving margin models, permitted margin thresholds, risk

management controls, and required documentation.

For example, with respect to the methodologies for calculating the amounts of margin, the comparability determination finds that the definitions of initial and variation margin are similar, including the description of potential future exposure agreed under the BCBS-IOSCO framework. Margin models or a standardized margin schedule may be used to calculate initial margin. Criteria for historical data to be used in initial margin models is similar. Initial margin models must be submitted for review by a regulator prior to use. Eligibility for netting is similar. Correlations may be recognized within broad risk categories but not across such risk categories. The required method of calculating initial margin using standardized margin rates is essentially identical, as is the prescribed standard margin rates themselves.

Where staff noted differences in other JFSA margin requirements, it also kept in mind

that the Commission's standard of review does not require identical or comparable requirements in every aspect. In these instances, staff discussed with the JFSA its supervisory position and then evaluated the purpose and effect of the particular JFSA margin requirements in light of the JFSA's supervisory authority.

Following this procedure, staff recommends that the Commission should find the JFSA's rules comparable in outcome. These rules include timing for collection of margin, the list of eligible collateral, requirements for custodial arrangements, and the cross-border aspects of the JFSA's rules.

Staff is not recommending that the Commission find comparability only in relation to margin requirements for inter-affiliate swaps. In this one instance, the JFSA's rules have no corollary to the Commission's rules, and pursuant to the cross-border margin rule, the Commission determined this rule to be of high importance for the purpose of preventing the evasion of initial

margin collection requirements through the use of affiliates.

Staff notes that we have a broad scope MOU in place with the JFSA and have established a close working relationship with the JFSA over many years. Commission staff believe that the JFSA has all the necessary powers to supervise, investigate, and discipline entities under their margin rules.

Finally, staff notes that under Commission regulations, all books and records required to be kept under Part 23 must be open to inspection by Commission staff and the Department of Justice. This comparability determination does not change these requirements. These requirements were explicitly retained under the 2013 comparability determination for Japan regarding recordkeeping requirements. Thus, the Commission will continue to be able to examine the books and records of Commission registrants to monitor for compliance with the CEA, CFTC regulations, and the terms of this determination.

I thank you for your attention. I would be happy to address any questions you have.

CHAIRMAN MASSAD: Thank you for that very excellent and informative presentation.

I will now entertain a motion to approve the comparability determination so that we may begin our discussion and consideration of this matter. Is there such a motion?

COMMISSIONER BOWEN: (off mic)

CHAIRMAN MASSAD: Yes, you will. We just need a motion first to begin the discussion.

COMMISSIONER BOWEN: Yes, okay.

CHAIRMAN MASSAD: Yes?

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: Okay. All right, I will now open the floor to allow the Commissioners to make any statements or ask any questions they may have. Commissioner Bowen?

COMMISSIONER BOWEN: Yes. Thank you. I, too, would like to thank the staff for all of its hard work in this matter. However, I cannot support it today. I will be voting no, as I think

it will introduce greater risk into the derivatives market, the very thing that we were sent here by the American people to prevent.

There are three questions I will answer in my remarks today: (1) What is a margin comparability determination, and why does it matter? (2) What are the problems with this particular determination? (3) How can we fix it?

For many Americans a margin comparability determination is truly a foreign concept, but actually has great significance to our economy. Margin is collateral. The 2008 derivatives market was under-collateralized, and that is what caused it to explode and take our economy with it. The American people expected us, as regulators, to fix that by requiring sufficient collateral to address the risk. We've done that with our margin rule.

In a margin comparability determination, we're defining when our U.S. Dealers that are operating in the other jurisdiction can ignore our margin rule and follow the other rules in that

jurisdiction. Allowing American companies to follow just one set of rules, that of the jurisdiction they're in, makes sense when the rules are basically accomplishing the same thing. I'm in favor of that.

International comity, harmonization across jurisdictions, and having an outcomes-based approach to comparability all makes sense. Unfortunately, that is not the scenario that we have here today.

While Japanese law has some strong similarities to our own, there are some areas of divergence that are significant and would allow American companies to do overseas what they would never be allowed to do here. And make no mistake, though these companies are physically located in Japan, their cash line runs right back to the United States. That risk could be borne again by American households.

A comparability determination should not be a backdoor way of undoing or weakening our regulations and thereby incentivizing our

companies to send their risky business to their affiliates located in Japan. That would not be good for our economy, for Japan's economy, or for the global financial stability overall.

This determination is doubly important, because it's the first one, and thus it sets the stage for others. By adopting a weak standard today, we pave the way for even weaker determinations in the future. Moreover, we're not establishing this determination in conjunction with the prudential regulators who oversee roughly half of U.S. swap dealers and are our counterparts on these issues.

We've worked effectively with our prudential counterparts thus far. Making this determination without harmonization amongst U.S. Regulators is ill-advised. Differences in requirements would only open the door to regulatory arbitrage domestically.

Second, what is the problem with this particular determination? The answer: Bankruptcy. Bankruptcy is something that we do

not like to think about, but in finance it's something that we must always consider when designing deals. We know the old adage, "Hope for the best but plan for the worst."

In my work as a law firm partner and as acting chair for Securities Investor Protection Corporation, I've seen too many bankruptcies. And there are three key differences in our margin rule and the Japanese margin rule that would leave our American companies operating under Japanese law vulnerable.

The key differences are: Where the customer money is kept. Our rules require collateral to be held by a third party, not by either one of the counterparties. This is a safeguard for bankruptcy. If the money is held by one of the counterparties, then a bankruptcy court may use that money to meet that counterparty's needs. Or in a stress scenario, the counterparty could potentially take the customer money to meet its obligation. If, however, the money is at a third party, it's far more likely that it will get

back to the customer that provided it. Japanese law does not have a comparable rule.

Thus, in a bankruptcy situation, U.S. Companies may be unable to receive back their customer funds. This discrepancy is noted in the determination, but the staff states that the fact that the funds are segregated sufficiently mitigates this risk. I disagree.

In my experiences with bankruptcies, I've learned that access to customer funds largely depends on the location of those funds. Third-party custodianship is an important safeguard.

There are certain developing countries where there is little certainty that collateral will be there if there is a bankruptcy or where they do not segregate customer funds from those of the dealer. Under our rules, our U.S. dealers have to limit the way they trade with counterparties in bankruptcy vulnerable jurisdictions, because we're not confident that our American investors would get their money back

in their bankruptcy scenario.

These safeguards vary depending on the circumstances and include limiting the amount of business that our dealers can do with these counterparts and limiting the type of acceptable collateral. Japan does not have these kinds of limits on their dealers. Thus, American companies operating in Japan could potentially have an unlimited amount of deals with counterparties in these bankruptcy countries. This could put some of our American firms at risk and thus our economy.

There are significant differences in the treatment of collateral between our rule and the Japanese rule. First, where our rules limit daily variation margin to cash, under Japanese law, variation margin could be in a number of much less liquid instruments.

And, second, while we require a 25 percent haircut for certain equities, under Japanese law equities would only be haircut by 15 percent. That means, in a crisis, American

companies in Japan could be exchanging instruments that are virtually worthless since they cannot be readily converted into cash, thereby putting them into jeopardy.

If these differences were insignificant, I would happily brush them aside. But these issues could mean the difference between an orderly bankruptcy and a disaster overseas that pulls down a significant part of the American economy.

And last, how can we fix this? Well, actually, fixing this would have been rather simple. We could have provided a partial determination. Our American businesses could follow the Japanese margin rule except in the areas above where they would have to follow our rule. We've already done this in the current draft in the area of inter-affiliate margin. We would simply extend the same treatment to these three areas as well. A partial comparability determination would be the best way to strike the right balance between international harmonization

and protection of American interests.

Thank you so much for allowing me to have my remarks today. Thank you again for the hard work.

CHAIRMAN MASSAD: Commissioner Giancarlo.

COMMISSIONER GIANCARLO: I have no statement.

CHAIRMAN MASSAD: Well, let me again thank the staff for the excellent work.

I support the determination of comparability with respect to Japan's rules. It's an important and necessary step toward building a strong international regulatory framework for over-the-counter swaps markets, and that's critical to ensuring the safety and soundness of our own financial markets. And I think we must keep in mind here that our laws and the laws of other jurisdictions will never be identical, and I think the comparability determination reflects that understanding. In this instance, as in other decisions, the Commission compared our margin rule

to each element of Japan's rules, carefully considering the objectives and outcomes overall. And we also, as the staff noted, considered another jurisdiction's supervisory and enforcement authority.

And there, you know, I want to note that we have a very strong and good relationship with JFSA. In fact, I met with Commissioner Mori and members of his staff just a few months ago, and there is I think a great amount of mutual respect, good communication, and cooperation. We've worked together very well on a number of issues, including the formulation of margin requirements. And I think this determination will strengthen that relationship. And I think it's important to step back because, really, the question here is, how do we get to a strong and sensible, and reasonably consistent international framework for the regulation of the derivatives market? And the margin rule is a key component of that, but it's only one component.

And first to the timing of the

implementation concerns, I have respect for Commissioner Giancarlo's comments on that point, but we chose to go forward with the timing, because the schedule was agreed to 18 months ago. This first phase only applies to a very small number of very large firms -- 20 firms. Several of them are European firms, and in their transactions with U.S. firms, they are subject to our rules. They are collecting and posting margin. And I think it's precisely for that reason that when the E.U. announced their delay, they actually told their firms to continue preparing to comply, because they were subject to the U.S. rules.

The E.U. leaders -- I met with several of them on this subject. They're also very committed to getting their rules in place. Hopefully, this delay will only be a couple of months. And I think the fact that we went forward has actually further incentivized them -- and other jurisdictions -- to move forward.

And as to the implementation, I would

simply point to the statement of the head of ISDA today that said -- and I quote -- that the rollout went relatively smoothly, given the scale of the change. So, you know, there were some specific problems that we addressed. We issued a no-action letter last week to address an issue on custodial arrangements, because we recognized that there are a limited number of providers of those services, and some firms were having trouble getting those agreements in place.

So, the fact that the E.U. delayed obviously wasn't ideal; it was a disappointment. But I think we will get to that international framework faster by having gone forward.

The same with this determination. I think it's important to remember that we're still at the early stages of building this framework. There are going to be differences. But I think overall, again, the margin requirements achieve comparable outcomes.

Think back to where we were two years ago, shortly after I took office. There were a

lot of differences in our rules, Japan's rules, E.U. rules. Other jurisdictions hadn't even begun their rules. They were waiting to see what we did. And this is not withstanding the fact that there was a BIS-IOSCO process, as Frank indicated, to arrive at a common standard. And we brought those rules together. We made tremendous progress in doing that.

And so the differences that we have, I think -- you know, we've highlighted one that we felt was important to take an exception to on inter-affiliate rules. I believe that exception is necessary to help address the risk that can flow back into the U.S. from offshore activity, even when the subsidiary is not explicitly guaranteed by the U.S. parent.

As to the other differences, I have great respect for Commissioner Bowen's concerns here. I think we share the same goal in terms of reaching a strong international framework. I'm sure the industry would prefer it if we could arrive at a single standard that is exactly the

same that everyone follows. But that is a difficult thing. As to the specifics: On haircuts, for example, yes, it is true that there is a slight difference, though it is pretty slight. We recognize a 15 percent haircut on the S&P 500 equities. We impose a larger one on S&P 1500 equities. Japan says 15 percent on major indices. On the other hand, Japan has a larger discount than we do on government bonds and corporate debt. So, in that sense, their rule is stronger than ours.

On the custodial arrangements, I also recognize the importance of protection of margin deposits in the event of bankruptcy, and that's why we, in our rule, require segregation, but that means is not commonly used in Japan. And that's why the Japan rules require the use of trust structures, which the JFSA has advised us are respected under their law in bankruptcy.

Also with respect to the non-netting jurisdictions, our rule requires a swap dealer to collect initial margin on a gross basis from a

counterparty in a jurisdiction that doesn't clearly recognize netting. The JFSA rule says that the dealer must establish an appropriate risk management framework that may but is not required to include collection of margin.

It's important to remember then, in considering outcomes, how this applies. We're not talking about American firms, U.S. entities, dealing with Japan counterparties being able to follow the Japan rule. We're talking about Japanese swap dealers who are registered with us. If those trades are guaranteed by a U.S. person, they must still follow our rules and collect margin according to our rules. If it's a Japanese swap dealer whose trades are not guaranteed by a U.S. person and who's not a foreign consolidated subsidiary, they are entitled to an exclusion anyway, regardless of what we do, on this substituted compliance determination.

So, it is Japanese swap dealers who are foreign consolidated subsidiaries that would be entitled to substituted compliance. But they

would still be subject, if they engage in these trades, to the JFSA risk management requirements, and any parent entity swap dealer would be subject to our consolidated risk management requirements. And here again, as I noted at the outset, I think our review of JFSA's supervisory and enforcement authority is relevant.

So, for those reasons, I believe it's important to grant this. And, again, I think we have to keep in mind that our goal is to build an international framework that is strong, that is sensible, and that is as consistent as possible. There are going to be differences. It is going to take time. But I think today's decision will contribute significantly to doing that and will help make sure the global derivatives markets continue to be dynamic and competitive.

Let me again thank our staff. Let me now ask if the Commissioners are prepared to vote?

COMMISSIONER GIANCARLO: Yes.

COMMISSIONER BOWEN: I'd like to just raise a couple of questions as well. I do want to

just stress: I, too fully support harmonization and working with Japan on this. But it makes a good difference to me where my customer funds are. As you guys know, I'm very much focused on that.

Because Japan has a system where IM does not have to be cash, you know, we run the risk that we may never get to that money. So, I just want to ask a question of the staff.

So, under our rules, initial margin must be with an unaffiliated third party, and any cash collateral must be reinvested by the counterparty in another eligible instrument. How do we reach the determination that that's comparable under Japanese law?

MR. FISANICH: Again, I would point to the fact that the standard of review doesn't require identical -- it's a -- as Chairman Massad was saying, you know, we're not going to get to the same place on everything, and in this case if the overriding purpose of a list of eligible collateral and the haircuts and what you can do with those things is substantially similar.

COMMISSIONER BOWEN: One other question: I assume that we decided we need to rush ahead with this in our work with our prudential regulators. Were there any areas of concern in your discussions with the prudential regulators?

MR. FISANICH: You know, we've had multiple -- not just this group but others in DSIO have had multiple conversations with the prudential regulators. They hold weekly calls. Any number of issues have been raised, including some that you've raised and some that we've raised -- inter-affiliate, custodial arrangements -- as they look at Japan. However, they are still in their process, and as far as we know they've not presented anything to their principles at this point. So, we don't know where they will come out.

CHAIRMAN MASSAD: Okay, Mr. Kirkpatrick, will you call the roll?

MR. KIRKPATRICK: The motion now before the Commission is on the approval of a comparability determination for Japan regarding

uncleared swap margin rules for substituted compliance purposes.

Commissioner Giancarlo.

COMMISSIONER GIANCARLO: Aye.

MR. KIRKPATRICK: Commissioner Giancarlo, aye. Commissioner Bowen.

COMMISSIONER BOWEN: No.

MR. KIRKPATRICK: Commissioner Bowen, no. Chairman Massad.

CHAIRMAN MASSAD: Aye.

MR. KIRKPATRICK: Chairman Massad, aye. Mr. Chairman, on this matter the ayes have 2; the no's have 1.

CHAIRMAN MASSAD: The ayes have it, and the motion to approve the comparability determination carries.

Do the Commissioners have any other Commission business?

COMMISSIONER GIANCARLO: No.

COMMISSIONER BOWEN: No.

CHAIRMAN MASSAD: If not, I would like to ask for the indulgence of my fellow

Commissioners just to say a brief word about my view of our priorities for the rest of the year.

First of all, let me just note that much of our work does not consist of writing and adopting rules, the typical subjects of our open meetings, such as this one. Instead, it is the critical work of compliance and examinations, and in particular we've had presentations from many of our staff today involved in that work. And that ensures that customer protection rules are observed and that customer funds are segregated, as Commissioner Bowen has rightly pointed out the importance of those things. And it involves conducting examinations of clearinghouses and clearing members. Also it is our surveillance and enforcement work to prevent fraud and manipulation. And those things are obviously -- will continue to be a focal point.

And, finally, that ongoing work includes the continuation of the important work we have been doing on CCP resilience, recovery, and resolution planning; and that will remain a key

priority for this fall, and you will hear more about that in the months ahead. We will also be continuing to make our work with international regulators on cross-border harmonization issues a priority.

But when it comes to the typical subjects that we bring to these open meetings, as you probably know we've implemented almost all the rules required by Dodd-Frank. We are now focused on fine-tuning those rules to make sure they are achieving their objectives and to address any unintended consequences. And we are focused on responding to new challenges in our markets, and today's action with respect to the system safeguards rules is an illustration of that.

Another example of that that we are focused on for the fall is our proposed rule on automated trading. A very good example of how we must address the new technological challenges in our markets. And on the subject of AT, let me just say that we have received a lot of feedback from commenters. It's been very helpful, and I

intend to ask my fellow Commissioners to support a supplemental proposal on certain issues related to this rule in the near future.

In addition, this fall I will ask my fellow Commissioners to consider a re-proposal of our rule setting capital requirements for swap dealers and major swap participants. That is one Dodd-Frank rule that we have not yet completed, and it's a critical part of the regulatory framework.

I will also ask them to consider a proposed rule addressing a number of issues related to the cross-border application of our swap rules that have been the subject of past guidance. And I expect that we will soon consider finalizing the new clearing mandates for interest rate swaps that we proposed earlier this year.

Now, further examples of fine-tuning I think will be a focus with respect to trading and data rules. I hope that we can consider some changes to improve trading on swap execution facilities that would be consistent with the

no-action letters we have issued on the subject. And I expect that we will have additional proposals to improve swap data reporting.

And, finally, I hope that we can finalize, as I've said before, our rule setting position limits by the end of the year.

Now, of course, that's an ambitious agenda. It's only possible because of the talented and dedicated staff at the CFTC. I want to thank all of our employees for their hard work on these and other important measures. And I also want to thank again Commissioner Bowen and Commissioner Giancarlo for their input, for their consideration of these rules, for their very helpful suggestions and their support of all that we are doing.

With that I will entertain a motion to close the meeting.

COMMISSIONER BOWEN: So moved.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: All in favor?

ALL: Aye.

CHAIRMAN MASSAD: The meeting is closed. Thank you all.

(Whereupon, at 11:16 a.m., the PROCEEDINGS were adjourned.)* * *

CERTIFICATE OF NOTARY PUBLIC

DISTRICT OF COLUMBIA

I, Carleton J. Anderson, III, 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.

(Signature and Seal on File)

Notary Public, in and for the District of Columbia

My Commission Expires: March 31, 2017