

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

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COMMODITY FUTURES TRADING COMMISSION  
PUBLIC ROUNDTABLE ON FUTURIZATION OF SWAPS

Thursday, January 31, 2013

Commodity Futures Trading Commission

1155 21st Street, N.W.

Washington, D.C.

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

2 PANEL 1

3 CFTC MEMBERS:

4 AARON BRODSKY

5 FRANK FISANICH

6 EVE GUTMAN

7 ABIGAIL KNAUFF

8 NANCY MARKOWITZ

9 SCOTT MIXON

10 RICHARD SHILTS

11 ANANDA RADHAKRISHNAN

12 DAVID VAN WAGNER

13 PANELISTS:

14 PAUL CAMPBELL

15 BRYAN DURKIN

16 TOM FARLEY

17 CHRIS FERRERI

18 GEORGE HARRINGTON

19 CLIFF LEWIS

20 WALT LUKKEN

21 JEFFREY MARON

22 LEE OLESKY

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

2 JOHN PARSONS

3 WILL RHODE

4 DEXTER SENFT

5 DON WILSON

6 PANEL 2

7 CFTC MEMBERS:

8 ANANDA RADHAKRISHNAN

9 TRACEY WINGATE

10 PANELISTS:

11 NEAL BRADY

12 JAMES CAWLEY

13 TOM FARLEY

14 JACK HATTEM

15 DANIEL MAGUIRE

16 DAVID OLSEN

17 SEAN OWENS

18 KIM TAYLOR

19 DON WILSON

20 LUKE ZUBROD

21

22

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

2 PANEL 3

3 CFTC MEMBERS:

4 AARON BRODSKY

5 EVE GUTMAN

6 ABIGAIL KNAUFF

7 NANCY MARKOWITZ

8 GEORGE PULLEN

9 MICHAEL PENICK

10 RICHARD SHILTS

11 SAYEE SRINIVISAN

12 DAVID VAN WAGNER

13 NHAN NGUYEN

14 PANEL MEMBERS:

15 NEAL BRADY

16 TOM CALLAHAN

17 JAMES CAWLEY

18 BRYAN DURKIN

19 WILLIAM EMMITT

20 TOM FARLEY

21 SUNIL HIRANI

22 JERRY JESKE

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

2 ROBERT LEE

3 WAYNE PRESTONE

4 BILL THUM

5 DON WILSON

6 PANEL 4

7 CFTC MEMBERS:

8 AARON BRODSKY

9 EVE GUTMAN

10 ABIGAIL KNAUFF

11 NANCY MARKOWITZ

12 GEORGE PULLEN

13 RICHARD SHILTS

14 DAVID VAN WAGNER

15 FRANIK FISANICH

16 SCOTT MIXON

17 MICHAEL PENICK

18 PANEL MEMBERS:

19 JIM ALLISON

20 PAUL CAMPBELL

21 LAEL CAMPBELL

22 THOMAS DEAS

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

2 LANCE KOTSCHWAR

3 DAVID FRENK

4 SALLY INGBERG

5 CHARLES REYL

6 LUKE ZUBROD

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## 22 Futures on End-Users

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

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

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

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

20 Chairman Gensler.

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



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

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

12 MR. MIXON: Two months.

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

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

22 These roundtables have helped us

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

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

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

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1 corporate bond market called TRACE.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

7 Bart, are you on the phone?

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

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

13 CHAIRMAN GENSLER: Bart, can you hear us?

14 (No response.)

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

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

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

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

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

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

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

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

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

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1 customers going forward.

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

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

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

15           Thank you.

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

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

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

22           COMMISSIONER CHILTON: Sorry about that. It's

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

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

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

22 There is one other concern though that I do



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

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

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

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

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

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

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

19           MR. RADHAKRISHNAN: Thanks, Rick.

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

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1 to come to the Commission today.

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

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

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

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

22 So the question which I'd like discussion on

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1 is:

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

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

8

9

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

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

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

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

3                   MR. SHILTS: Thanks, Ananda.

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

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

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

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

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

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

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

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

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

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1 will go for an hour and 15 minutes.

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

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

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

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

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

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

5

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

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

11                  MR. SHILTS: We can finish up here.

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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1 MR. SHILTS: Okay. Thanks to all.

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

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

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

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

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

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

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

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

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

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

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

19           MR. SHILTS: Tom.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

4 Thanks.

5 MR. SHILTS: Thanks. George?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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1 extremely costly to the American consumer.

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

5           Thank you.

6           MR. SHILTS: Okay. Thanks.

7           Lee.

8           MR. OLESKY: Thank you.

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

3 Thanks very much.

4 MR. SHILTS: Okay. Thank you.

5 Jeffrey.

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

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

22 We recognize that market participants trading

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



1 last.

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

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

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

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

17

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

21           MR. SHILTS: All right. Thank you.

22           Cliff?

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

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

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

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

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

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

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

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

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

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

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1                   Let me just make two last concluding points.

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

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

22                  And the last point, if you want to worry

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

17 Thank you.

18 MR. SHILTS: All right. Thank you.

19 Don?

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



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

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

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

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

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

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

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

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

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

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

22           Once again, I would like to thank the

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1 Commission for inviting me here. And thank you.

2 MR. SHILTS: All right. Thanks.

3 Walt?

4 MR. LUKKEN: Thanks, Rick.

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

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

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

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

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

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

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

17           MR. SHILTS: All right.

18           Dexter?

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

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

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

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

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

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

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



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

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

12           Thank you.

13           MR. SHILTS: All right.

14           Chris?

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

22           I would like to briefly discuss the history

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

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

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

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

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1 of interstate commerce.

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

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

22           Relating a swap product as a future should

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

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

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

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

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

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

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

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

6 MR. SHILTS: All right. Thank you.

7 Paul?

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

22           Ananda, to speak to your question, I think

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

20                   Thank you.

21                   MR. SHILTS: All right.

22                   John?

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

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

13           (Laughter.)

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

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

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

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

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

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

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



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

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

1 plays itself out as you define the rules.

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

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

22           Thanks for the opportunity to be here.

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1           MR. SHILTS: Thank you very much.

2           And thank you to everyone for your comments.

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

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

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

9 MR. SHILTS: Anyone else?

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

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

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

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

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

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

5               Yeah, Bryan?

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

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

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

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

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

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

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

3 (Laughter.)

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

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

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



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

4 MR. SHILTS: Yeah, Bryan.

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

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

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

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

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

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

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

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

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

19           MR. SHILTS: Thank you.

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

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

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

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

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1 responsibilities.

2 MR. SHILTS: Well, we've gone a little over.

3 Does anyone else have one last comment before we close  
4 this session?

5 (No audible response.)

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

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

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

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

12 MR. SHILTS: Yeah, Bryan?

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

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

17 (Laughter.)

18 COMMISSIONER WETJEN: Okay.

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

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

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

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

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

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

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

19           MR. SHILTS: Yeah, Dexter.

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



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

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

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

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

10 MR. WETJEN: Thanks very much.

11 MR. SHILTS: Commissioner O'Malia.

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

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

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

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

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

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

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

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1 not be enough liquidity in that market to exist.

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

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

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

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

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

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

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

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

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

6 MR. SHILTS: Any other comments?

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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1 should be subject to your oversight.

2 MR. SHILTS: Any final comments?

3 (No response.)

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

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

11 MR. SHILTS: So by 11:40.

12 (A brief recess was taken.)

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

20 So thank you.

21 MR. RADHAKRISHNAN: So thank you very much.

22 This is the second panel on clearing and margin

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

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

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

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

13 MR. ZUBROD: Luke Zubrod, Chatham Financial.

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

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

18 MS. TAYLOR: Kim Taylor, CME Clearing.

19 MR. OWENS: Sean Owens, Woodbine Associates.

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

22 PTG.

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1 MR. BRADY: Neal Brady, Eris Exchange.

2 MR. HATTEM: Jack Hattem, BlackRock.

3 MR. MAGUIRE: Daniel Maguire, LCH Clearnet  
4 Group.

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

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

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

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

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

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

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

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

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

16           Hey, Tom, welcome back.

17           MR. FARLEY: Sorry. Thanks.

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13           Thank you.

14           MR. RADHAKRISHNAN: Jamie.

15           MR. CAWLEY: Thanks, Ananda.

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

22           Swaps and futures in swaps are economically

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

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

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

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

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

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

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

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1 clearinghouse.

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

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

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

22           Or consider the product with the higher

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

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

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

22           Swaps already liquid will increase in volume



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

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

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

11 MR. RADHAKRISHNAN: Thanks, Jimmy.

12 Dave.

13 MR. OLSEN: Thanks.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

22           Thank you.

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1 MR. RADHAKRISHNAN: Thanks, Dave.

2 Sean.

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

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

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

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

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

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

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

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

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

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

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

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



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

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

15           So thank you.

16           MR. RADHAKRISHNAN: Thanks, Sean.

17           Don.

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

22           To summarize what I said before, futurization

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

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

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

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

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

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

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

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

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

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

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

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

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

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

14           Thank you.

15           MR. RADHAKRISHNAN: Thanks, Don.

16           Neal, I'm going to skip you.

17           MR. BRADY: Okay.

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

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

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

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

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

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

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1 aids.

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

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

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

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

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

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



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1 allowing fundability across CCPs.

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

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

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

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

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1 they caused huge credit issues.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

22           It's much easier for a wider variety of

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

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

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

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1     that.

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

4                     MR. RADHAKRISHNAN:   Thanks, Kim.

5                     Dan?

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

22           And I think one of the testaments to that

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

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

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

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

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

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

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

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

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

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

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

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

9 MR. RADHAKRISHNAN: Thanks, Dan. Neal?

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

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

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1 physically deliver into swaps.

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

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

22           We believe that the Commission's finalized



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

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

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

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

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

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

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

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

7           Thanks.

8           MR. RADHAKRISHNAN: Thanks, Neal. Tom?

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

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

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

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

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

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

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

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

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

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

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

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1 people competing on risk.

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

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

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

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

6 Thank you.

7 MR. RADHAKRISHNAN: Thank you.

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

19 MR. RADHAKRISHNAN: All things remaining  
20 equal -

21 -

22 MR. CAWLEY: Right.

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

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

6           MR. RADHAKRISHNAN:  Yes, yes.

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

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

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1 marketplace. And that is going to change.

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

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

22           So what we do every day, we are religious

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

12 MR. FARLEY: Thomas Farley,  
13 IntercontinentalExchange.

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

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

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

20 MR. LEE: Robert Lee, Deutsche Bank.

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

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

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

3                   MR. BRADY: Neal Brady, Eris Exchange.

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

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

8                   MS. KNAUFF: Thank you.

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

4 That's all I have.

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

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

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

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

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

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1 not sacrifice liquidity at the altar of transparency.

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

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

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

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

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

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

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

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

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

18 Thank you.

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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1 threshold for that instrument.

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

10           Thank you.

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

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

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

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

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

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

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

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

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

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

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

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

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

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1    should be applied in assessing blocks.

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

10 Thank you very much.

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

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

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

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

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

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

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

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

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1 and offers to the extent that trading activity grows.

2 Then the CFTC can monitor the growth the data provided.

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

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

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

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

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



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1 on a SEF.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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1 maximum amount of flexibility.

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

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

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

22           We invest in upstream assets. We manage

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

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

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

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

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

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

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

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1 US.

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

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

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



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1 markets.

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

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

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

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1 and should not be tampered with.

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

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

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

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

22 FIA PTG also supports the notion that block

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

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

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

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

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

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

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

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

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

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

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

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

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

10           MR. WILSON: Go ahead, Bryan. Yeah, I think  
11 it's a question of large compared to the size of the  
12 central limit order book in a given product. And the  
13 energy market is a very interesting example. I think  
14 that perhaps the block thresholds in the energy market  
15 right now are not sufficiently granular. Certainly in  
16 a front month product that's very liquid, it's entirely  
17 reasonable to set a block threshold that's higher than  
18 for a month that's difficult to price, that's very  
19 opaque, is difficult to source liquidity in and doesn't  
20 - - just doesn't exist on the screen.

21           MR. JESKE: Rick, maybe I can jump in since  
22 Don mentioned energy. Not to be cliché, size matters.

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1 But the liquidity that people are speaking of, I think,  
2 is paramount. I use the example of electricity. You  
3 have megawatt hours. You have nodes that are being  
4 traded around this country. There are tremendous  
5 amount of illiquid potential products out there.

6           So how do you put a buyer and a seller  
7 together? Do you force them to go to the central limit  
8 order book for the sake of price discovery? I say not.  
9 I say you allow those counterparts to come together,  
10 whether it's through a voice broker or through an  
11 exchange, to have the ability to be able to make that  
12 transaction transparent.

13           But when you only have two people in the  
14 marketplace or three or four or five, they need to be  
15 able to seek one another out. And for the commission  
16 to actively set an arbitrary number is just -- will  
17 destroy the markets -- in the small markets, as well as  
18 those that could develop into larger markets. So when  
19 you -- when you get to the concept of size, I think  
20 that's secondary. I think you really have to look at  
21 the type of market.

22           MR. DURKIN: Having recently gone through

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1 this in, you know, great, laborious detail, I would  
2 agree with both of actually what Don and Jerry stated.  
3 I mean, you have to look at -- when you're talking  
4 about over 1000 products in the energy space that  
5 you're trying to respond to a marketplace that has  
6 obviously spoken loudly that there is a need for these  
7 risk management tools, and you look at the more liquid-  
8 type contracts that are bit more conducive to a CLOB-  
9 like environment, you will see a greater correlation of  
10 higher block thresholds associated with those  
11 particular products.

12           As you move into some of the other more  
13 esoteric products, and particularly, as you're dealing  
14 with options that are linked to a variety of other  
15 energy- related instruments, it becomes a bit more  
16 complex. And your -- you know, your realm of user base  
17 and the liquidity associated with that could be as low  
18 as what Jerry had just described. And so that  
19 predicates a lower threshold.

20           You know, when we went through this for the  
21 conversion of all of our products, we did do it in --  
22 there was a semblance process that we went through. And



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1 we took all of the available market information data,  
2 liquidity elements, the uniqueness and structure of the  
3 product to come up with the levels that we chose.

4           Some of those that we came out with, the  
5 commission may recall, we got a resounding response  
6 from the marketplace that they were unusable. And this  
7 was particularly in the power segment. And when you go  
8 into power and you look at the complexity of how that  
9 power market is calculated, it resonates with you to  
10 understand why you have to have a much lower level,  
11 bases how that market trades and is priced.

12           So it is not a one-size-fits-all equation,  
13 you know, I assure you. And it's something that needs  
14 to take very much into consideration the risks  
15 associated with every one of those products in the  
16 market that you're trying to serve.

17           What's been very beneficial by all of this is  
18 the greater transparency behind the establishment of  
19 these block transactions, the reporting information and  
20 the ability now to be building up more historical data  
21 for us to benchmark and base our calibrations off going  
22 forward.

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1           MR. HIRANI:   Would it be possible to add  
2 something to that?

3           MR. SHILTS:   Yeah, just if maybe one more.  
4 And I don't know if -- Commissioner O'Malia, are we --  
5 do you have any questions? But, yeah, maybe this will  
6 be about it because we want to try to end this fairly  
7 soon. Because for our fourth panel, you know, some  
8 people have to leave and they may not be able to sit  
9 through the whole thing. So maybe just maybe one more  
10 comment and maybe one question. And then --

11          MR. HIRANI:   Sure.

12          MR. SHILTS:   -- we'll wrap it up.

13          MR. HIRANI:   I very much agree with what  
14 Jerry and Bryan said. What you're hearing them say is  
15 the energy market is very complex and there's certain  
16 instruments that are very, very liquid, deep  
17 transparent that trade on a CLOB. But what they're  
18 also saying is that there's thousands of other  
19 instruments that are illiquid that don't lend  
20 themselves to a CLOB that require a lower block  
21 threshold.

22                 And that's exactly the analysis and the

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1 thought process that I would encourage you to look at  
2 for the interest rate swaps market. Because you have  
3 2s, 5s, 10s, 30s that are very, very liquid that, I  
4 believe, are futures-like that should be traded on a  
5 DCM, on a CLOB.

6 But for all those other instruments, that  
7 Vanguard and other asset managers all over the world,  
8 including hedge funds, will be doing, allow those  
9 instruments to be traded exactly using the same  
10 analysis that Jerry and Bryan have outlined, to trade  
11 them using a block size -- a lower block size than you  
12 would for 2s, 5s, 10s, 30s, and allow those instruments  
13 to be traded -- exchanged for physical and exchanged  
14 for risk. Thank you.

15 MR. PULLEN: Rick, can I follow up with that?  
16 I had a question on that. So in follow-up -- and I've  
17 heard many comments along this same ilk, but I've heard  
18 no consideration of portfolio of risk, except by Mr.  
19 Thum from Vanguard, where he talked about his hedging  
20 of the risk on a portfolio basis.

21 But liquidity providers are also looking at  
22 risk in that same way. Whether those are liquidity

1 providers on your exchanges or on your future SEFs,  
2 they're providing that liquidity based on a portfolio.  
3 So I have a hard time following the logic that a two-  
4 year and a two-year two-day should have different block  
5 sizes. If everyone would like to elaborate, that'd be  
6 great.

7 MR. CAWLEY: Yeah, let me see if I can help  
8 elaborate on that. The notion of parsing, certainly in  
9 the interest rate swap markets, the liquid points on a  
10 curve, 2s, 3s, 5s, 7s, 10s and so forth, what happens  
11 then when you take exactly a five-year, which is highly  
12 liquid and no one disputes to trade in block and  
13 whether trade on the central limit order books or what  
14 not, it's -- we all agree that it's more liquid than,  
15 say, a four- and-a-half year.

16 But then what happens with that swap is it  
17 rolls down the curve and it's no longer a five-year.  
18 What do you do with it then? So you're right George;  
19 you have to look directly at what market practitioners  
20 in the interest rates market do today and that is when  
21 -- you know, I get hit with 7.2-year swaps, I'm looking  
22 -- I'm going to look -- going to hedge that with a

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1 basket of 7s and 10s. I'm going to take my two most  
2 liquid points around that swap and hedge it.

3               So -- and if I'm going to do that, I should  
4 really consider -- or you should really consider -- or  
5 it should be considered the liquidity of both the 7-  
6 year and the 10-year swap around it. So don't only  
7 just consider the liquidity in the particular widget.  
8 Again, interest rate swaps -- and I'm not an expert on  
9 energy. But I'll tell you, interest rate swaps are  
10 traded on a portfolio basis.

11              We don't go out and hedge individual swaps  
12 piecemeal. It would be inefficient and impractical. So  
13 again, when you get hit with something between liquid  
14 curve points, you have to consider the -- if you're  
15 going to hedge using liquid curve points, you should  
16 consider the liquidity of those curve points than in  
17 your block trade threshold.

18              And, you know, one further just point on  
19 that. If I take two-year swaps or one-and-a-half-year  
20 swaps and hedge it with a Eurodollar strip, well, then  
21 shouldn't I also consider the liquidity in the strips -  
22 - in the Eurodollar market and -- as part of that

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1 calculation as well?

2           So, you know, the idea here is on one side  
3 you want to promote transparency. And I agree with Don  
4 in terms of, you know, you want to properly -- you want  
5 to have a -- you know, an orderly functioning market.  
6 And you don't want to penalize guys who want to make  
7 large markets. But also, you want to incentivize  
8 transparency within limit order books to the extent  
9 that you can.

10           So I would argue that -- exactly what you  
11 just alluded to, which is consider it on the portfolio  
12 basis.

13           MR. SHILTS: Any more comments about that?

14           MR. SRINIVASAN: Can I ask one question?

15           MR. SHILTS: Sure.

16           MR. SRINIVASAN: Thank you. So, you know, we  
17 were looking at the data for the energy complex. And  
18 there have been comments that we should be looking at  
19 the liquidity of the contracts to figure out the block  
20 thresholds. And we see that there are contracts which  
21 trade -- so in all over 10,000 contracts a day at  
22 least. It's a large number of contracts, which are

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1 pretty liquid.

2 But we do see that the majority of the  
3 trading activity of these energy contracts happening  
4 through blocks. So -- and earlier they were  
5 EFSs; now, it's happening through blocks. So  
6 the question is, you know, the futures industry, the  
7 same as it always has been, if you're doing over 5000  
8 contracts a day, then it's a liquid market.

9 So we are -- we do see the data. There are a  
10 decent number of contracts -- energy contracts which  
11 are doing over 5000 contracts a day. But -- so the  
12 majority of the trading activity is happening through  
13 the blocks. And the block size -- and if you compare  
14 those with equal and non-energy contracts with similar  
15 volumes, those non- energy contracts have a much larger  
16 minimum block thresholds. It can be, like, 200  
17 contracts for a non- energy contract. But for that  
18 energy contract, it would be 25 contracts or 5 or even  
19 1.

20 So we're just trying to figure out, you know,  
21 how do we make sense? So we're looking at the  
22 liquidity, going by, you know -- if you just look at

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1 what's being printed on the exchange, it seems liquid,  
2 right? But if you looked at the block thresholds,  
3 they're really high. The block thresholds are low and  
4 the block activity is pretty high.

5           So, you know, what are we doing? Do we look  
6 at different sectors differently or do we just say --  
7 go by the trading activity and say, "Okay. This is a  
8 liquid contract and this should be treated like any  
9 other liquid futures contract?"

10           MR. FARLEY: I'll just make a couple of quick  
11 comments, Bryan. The conversation, at least in ICE's  
12 case, from swaps to futures, we view it as a fairly  
13 fundamental event. And, you know, our kind of internal  
14 mantra was a version of the Hippocratic Oath, "Do no  
15 harm." And the market largely is traded as you  
16 described.

17           So in the -- whatever particular contract  
18 you're describing, 10,000 a day that does some high  
19 percentage of blocks, that's how it -- that market had  
20 evolved. And on ICE, we had always made a central  
21 limit order book available to customers alongside block  
22 trade -- block trading. And the market, for whatever



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1 reason, in that particular case had evolved in that  
2 way.

3               So as part of the conversion, our goal was to  
4 do no harm and provide the ability both the Friday  
5 prior to our conversation, as well as that Monday  
6 morning when we were a futures for the market to  
7 continue to behave as it always has. I would give it  
8 some time. This was just October.

9               MR. SHILTS: Right.

10              MR. FARLEY: These markets are now futures.  
11 My sense is that they will evolve. You probably will  
12 see more central limit order book trading. And I think  
13 it's probably a more interesting intellectual or  
14 academic conversation six months from now or a year  
15 from now, once the -- you know, that these markets as  
16 futures have had a chance to mature.

17              MR. JESKE: I would add to that comment,  
18 certainly from a user's perspective, what you're  
19 talking about is electronic screen-based trading versus  
20 voice broker trading. And I think, as Bill mentioned,  
21 you've got the broker community out there that's trying  
22 to provide that liquidity. Call it an EFS. Call it a

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1 block. It's irrelevant.

2           Those transactions have grown up in the voice  
3 broker community. You can't flip a switch overnight  
4 and make it different. You can't make people behind  
5 their desks start trading on a screen immediately.  
6 That's -- the point Tom made about give there some time  
7 is absolutely correct. People aren't going to change  
8 their customer practice overnight.

9           The change between EFS and block has been a  
10 very constructive one because it's streamlined. You  
11 don't have two swaps anymore. You have one  
12 transaction. It's a lot less clunky. The market likes  
13 it. It works. As it relates to the broker community,  
14 if everything's forced into a central limit order book,  
15 you're forcing the brokers out of business to a large  
16 extent. And I don't think that's good for anybody.

17           Certainly in the physical world, you have to  
18 have brokers communicating. Again, there's not enough  
19 counterparties out there. And, you know, we strongly  
20 believe that the commission should do nothing to chase  
21 away counterparties in a nutshell.

22           MR. THUM: If I could just --

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1           MR. SHILTS: All right. Yeah, maybe one last  
2 comment. Because we don't want to lose our panelists  
3 for the next panel.

4           MR. THUM: Sure. Real -- just real quick. In  
5 our letter from May, we quoted a study from ISDA that  
6 showed the average daily trading volume for all  
7 interest rates derivatives is 6800 trades, of which  
8 2500 are new price-forming trades. The most popular,  
9 the US dollar ten-year swap, trades on average of 200  
10 times a day.

11           So while the breadth of the market is huge,  
12 the depth of the market is actually pretty shallow. So  
13 when you think about the current proposal, which has  
14 extremely large block sizes in the proposal, it's  
15 really out of whack, given the actual liquidity that's  
16 presented by these products. So if those proposals  
17 continue on, it will really disrupt the available  
18 liquidity, the products and certainly the price that  
19 we, as users, get for trading those products, given the  
20 depth is so small.

21           MR. SHILTS: Well, thank you all for your  
22 participation on the panel. It's -- I think we'll

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1 take, like, a five-minute break. Maybe at 3:10 we'll  
2 start back. Thank you.

3 (WHEREUPON, the meeting went off record from  
4 3:02 p.m. to 3:10 p.m.)

5 MR. SHILTS: If everyone wants to take their  
6 seats so we can get started on the last panel? Thank  
7 you.

8 MS. GUTMAN: Thank you all for being here.  
9 I'm sorry it's running a little late. Panel 4 will  
10 focus on the effect of the conversion of swaps to  
11 futures on end users specifically and any issues or  
12 changes regarding consistency between swaps and futures  
13 regulations to existing regulations or to future Dodd-  
14 Frank rulemakings to address these effects.

15 Please elaborate on how this affects your  
16 trading and hedging strategies as end users in deciding  
17 whether to use swaps or futures. Before we begin this  
18 discussion, I'd like to go around the table and have  
19 everyone introduce themselves and identify who they  
20 represent.

21 MR. ALLISON: I'm Jim Allison. I'm the  
22 global risk manager for ConocoPhillips.

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1 MR. REYL: Charles Reyl, CEO, Parity Energy.

2 MS. INGBERG: Sally Ingberg. I work at  
3 Forest City Enterprises, a real estate company.

4 MR. CAMPBELL: Lael Campbell, Exelon, where  
5 I'm responsible for the energy trading compliance  
6 program.

7 MR. DEAS: I'm Tom Deas, vice president and  
8 treasurer of FMC Corporation. And I'm chairman of the  
9 National Association of Corporate Treasurers.

10 MR. KOTSCHWAR: I'm Lance Kotschwar with  
11 Gavilon here on behalf of the Commodity Markets  
12 Council.

13 MR. ZUBROD: Luke Zubrod with Chatham  
14 Financial, a risk management advisory firm.

15 MR. FRENK: David Frenk, the research  
16 director of Better Markets.

17 MR. CAMPBELL: I'm Paul Campbell with  
18 Deloitte and run our energy regulator and risk  
19 practice. I'm not representing any clients here. I'm  
20 just on behalf of Deloitte.

21 MS. GUTMAN: Okay. Thank you. To quickly  
22 review the format, we will have each panelist provide

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1 their prepared remarks for four minutes or less. Once  
2 we hear the panelists' prepared remarks, we will then  
3 start an open discussion. So that we can hear from  
4 everyone, please hold your follow-up comments until  
5 either your remarks or until after all panelists have  
6 had the opportunity to make their prepared remarks.

7 And we will start with you, Jim Allison.

8 MR. ALLISON: Thank you. And I appreciate  
9 the opportunity to be here for this roundtable to  
10 discuss these implementation issues. As I said, I'm  
11 Jim Allison. I'm the manager of global risk for  
12 ConocoPhillips. ConocoPhillips is the largest North  
13 American-based, independent exploration and production  
14 company, based on production and reserves.

15 We're headquartered in Houston, Texas. We  
16 have operations and activities in 30 countries and  
17 about 17,000 employees. Because we're a producer of  
18 crude oil and natural gas, we're also a marketer of  
19 those vital energy commodities. And we use energy  
20 derivatives in connection with those marketing  
21 activities.

22 Derivatives, both futures and swaps, are

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1 tools, not ends of themselves. For these to work well,  
2 two things must be true. The tool must be well suited  
3 to the task and we have to know how to use the tool.  
4 From that perspective, the futurization of swaps is a  
5 good thing mostly. I'll come to my caveat at the end  
6 of the presentation.

7           For transactions that are standardized and  
8 appropriately cleared, futures are well suited to the  
9 task. The development of cleared swaps over the last  
10 decade was a useful innovation at the time but the  
11 distinction between a cleared swap and a future may no  
12 longer be useful. Preserving a distinction that is not  
13 useful adds unnecessary complexity for market  
14 participants and for regulators. In short, it appears  
15 to me that cleared swaps is now a redundant distinction  
16 in the marketplace.

17           Futures do what we need those transactions to  
18 do. Futures markets have evolved to facilitate the  
19 breadth of transactions we need. Therefore, it's  
20 important that futures regulation continue to evolve  
21 with the markets to continue to enhance the efficiency  
22 of the markets, which was, of course, one of the

1 original goals of Dodd-Frank.

2

3

4

5 One particular way in which regulation should  
6 evolve is with respect to how these positions get  
7 created. I'm referring here to block transactions,  
8 which has been the topic of much discussion in the  
9 previous panels. So let me just echo a few of the  
10 themes that resonated with me from the previous  
11 discussion.

12 Much of the liquidity in the energy  
13 derivatives is now on the electronic platforms and that  
14 creates much better transparency than anybody could  
15 ever have imagined in the days of the trading pits. But  
16 the trades that are blocked in are still an important  
17 supplement to those.

18 From our perspective, the DCMs ought to  
19 retain the flexibility to manage the block limits, as  
20 we heard discussed in the previous panel. Block size  
21 should be related to liquidity, with lower liquidity,  
22 meaning lower thresholds for block sizes. So to the



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1 previous question of how big is a block, big should be  
2 judged in my view relative to the trading activity in  
3 that particular instrument.

4           And as was noted, we are evolving from a  
5 previous world into this world of a pure futures  
6 transaction. We're not fully evolved in that space  
7 yet. So you see some things in the data that may not  
8 look completely normal to you. But the evolution is  
9 continuing.

10           We also need to recognize the role that the  
11 voice brokers or other facilitators have played in the  
12 market. They play an important role in the physical  
13 market. They have played a role in the EFS market and  
14 now in the block market. And in particular, they also  
15 play a role in the market for bespoke swaps. So  
16 whatever it is we do from a regulatory perspective, we  
17 need to preserve the role of those facilitators, such  
18 as the voice brokers.

19           We've also heard a lot of discussion about  
20 the need for a level playing field, setting aside Mr.  
21 Parson's concerns about how level is level. From my  
22 perspective, if we accept that futures and cleared

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1 swaps are functionally equivalent, that the category we  
2 call cleared swaps is, in that sense, redundant, then  
3 there is no potential for regulatory arbitrage because  
4 there is only a single regulatory structure appropriate  
5 -- that is the structure for futures.

6 All in all, so far as cleared swaps are  
7 concerned, my complaint is that futurization may not  
8 yet have gone far enough -- again, specifically these  
9 concerns about block sizes. But as I said, there is a  
10 maybe. There are other swaps to consider. While I'm  
11 comfortable regarding cleared swaps as futures, we must  
12 also assure that the market deals properly with  
13 transactions that are not appropriate for clearing.

14 There are at least two reasons why a swap  
15 would not be appropriate for clearing. First, the swap  
16 might be bespoke, so that it doesn't fit easily into  
17 the clearing framework. Second, the swap might be a  
18 hedge and clearing might have the perverse effect of  
19 increasing the risk the hedge was intended to reduce.  
20 The case of bespoke swaps has, I think, been adequately  
21 covered. The impact of clearing on the performance of  
22 hedge perhaps has not.

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1           There was discussion earlier that risk  
2 doesn't go away; it is simply transformed. This is an  
3 example of clearing transforming counterparty risk into  
4 liquidity risk. So the issue arises because clearing  
5 requires daily margining. As a result of the  
6 margining, the daily and monthly cash flows from the  
7 derivative are very different from the cash flows  
8 generated by the asset hedge.

9           An entity that was hedging for the purpose of  
10 smoothing cash flow would discover that clearing would  
11 result in cash flow that was more volatile than it  
12 would have been without the hedge. So it is essential  
13 that hedges be exempted from the clearing mandates. And  
14 of course, the statute does that.

15           My concern then is to assure that the trend  
16 toward futurization does not drive these transaction  
17 types, which must remain swaps, out of the market.  
18 These non-cleared swaps may require more bilateral  
19 discussion before a transaction can be consummated,  
20 either to customize terms or to arrange credit support  
21 other than clearing. Electronic transaction platforms  
22 by themselves do not handle that sort of negotiation

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1 well.

2           In the current state, voice brokers play an  
3 important role in bringing the ultimate counterparties  
4 together. And it's important that role continue.  
5 Fortunately, if, as I was recommending earlier, the  
6 regulations continue to allow easy access to block  
7 futures, I'd expect that activity to help assure the  
8 continued role of the voice brokers.

9           Thank you and I'll answer questions later.

10           MR. REYL: Thank you very much for the  
11 opportunity to participate in this roundtable. I am  
12 Charles Reyl, CEO of Parity Energy. We are an exempt  
13 commercial market and a broker for commodities. My  
14 goal today is to share with you my experience on the  
15 ground in the energy markets, more specifically, the  
16 energy options markets, which have been directly  
17 impacted by the futures to swaps transition.

18           In 2008, Parity Energy launched the Parity  
19 Energy Platform, or PEP, as an exempt commercial market  
20 for cleared energy options. And right from the start,  
21 PEP incorporated many of the futures that a proposed  
22 SEF rule would later require of swap execution

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1 facilities.

2           Since 2008, Parity has offered many -- to  
3 many an electronic order book, firm bids and offers,  
4 requests for quotes, pre- and post-trade transparency,  
5 as well as a very robust voice brokerage service. Now,  
6 over, you know, 175 institutions have access to PEP,  
7 including end users, energy producers and marketers,  
8 banks and hedge funds. These institutions have come to  
9 rely on Parity for price discovery and trade execution  
10 services.

11           Now, prior to the swaps to futures  
12 transition, Parity was on track to become a SEF. And  
13 given the overwhelming rejection of swaps by the energy  
14 trading community, we now don't see the point anymore.  
15 Whether to apply for SEF status or not will depend on  
16 the final rules for DCM Core Principle 9, minimum block  
17 thresholds and SEFs.

18           So before October 14, 2012, energy swaps  
19 included everything that did not trade on a central  
20 limit order book or open outcry. So most of this  
21 market traded through inter-dealer voice brokers. So  
22 again, for instance, in energy options, swaps

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1 represented about 80 percent of the overall trading  
2 volume -- so in terms of volume.

3           So since then, all market participants -- or  
4 nearly all market participants have moved from swaps to  
5 futures. And I think, as Tom Farley of ICE earlier  
6 mentioned, customers just love it. And rather than  
7 migrating to central limit order books, most of these  
8 energy swaps continue to be negotiated off exchange,  
9 through voice brokers before being posted as futures  
10 blocks.

11           So I think this is important because what it  
12 means is that customers did not switch to -- because of  
13 greater liquidity or convenience, but mainly because  
14 they wanted to avoid stiffer swap regulations. So by  
15 definition, off exchange trading activity on the DCM  
16 should be the exception rather than the norm. But any  
17 effort to address this issue in the absence of a  
18 strong, viable swaps alternative is likely to cause the  
19 market to die from lack of liquidity information.

20           And this would severely hurt end users and  
21 any other market participants who rely on such  
22 derivatives for their risk management. So for Parity

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1 specifically, the futurization of the energy markets  
2 has reduced the value proposition of its electronic  
3 services. So Parity now functions through its futures  
4 entity in order to broker block trading of futures  
5 contracts on various DCMs.

6           Because those DCMs prohibit the use of  
7 transparent, electronic off exchange matching, PEP now  
8 functions as a white board, showing only indications of  
9 interest. So all transactions we facilitate today must  
10 be consummated by voice and with help from the market  
11 until they are reported to the DCM. This is a step  
12 backward compared with Parity's original transparent  
13 electronic matching as an ECM.

14           Namely before the futurization, over-the-  
15 counter derivatives were electronically traded on PEP  
16 with full pre- and post-trade transparency for all  
17 participants. And now, ironically, after the  
18 futurization, all trades are exclusively voice brokered  
19 and the real time transparency Parity used to offer is  
20 prohibited.

21           So as a result, I respectfully ask the  
22 Commission to determine whether it is in the interest

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1 of end users and other market participants for DCMs to  
2 have rules which prevent the facilitation of block  
3 trades on a system that's accessible to multiple  
4 participants and that allows for electronic matching.

5           Also, I think we should really make swaps a  
6 genuine alternative to futures blocks. And if the  
7 commission regulates end users who trade swaps and swap  
8 dealers more strictly than any futures market  
9 participant, then maybe it should make swaps more  
10 flexible in return, which I think is the idea.

11           For instance, in terms of, you know, minimum  
12 block size or by allowing a variety of trade execution  
13 mechanisms for swaps, including the RFQ, auction,  
14 voice, as long as appropriate minimum levels of pre-  
15 trade transparency are achieved.

16           But in any case, we feel that the minimum  
17 block thresholds for futures should not be raised until  
18 either central limit order book trading takes off or a  
19 viable swaps alternative is made available.

20           On behalf of Parity, I thank you very much  
21 for the opportunity to share our thoughts and I look  
22 forward to answering any questions.



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1                   MS. INGBERG: Hi. Thank you for allowing me  
2 to speak today about the futurization of swaps. My  
3 name is Sally Ingberg and I'm vice president of debt  
4 management at Forest City Enterprises, which is a  
5 national real estate company headquartered in  
6 Cleveland, Ohio.

7                   One of my main responsibilities is to  
8 coordinate our derivative risk management strategies on  
9 behalf of the company. These derivatives are simply  
10 used to mitigate interest rate risk on our mortgage and  
11 corporate debt financings. This is done to minimize  
12 our -- the exposure to our largest single expense,  
13 interest expense.

14                  Derivatives have been an extremely useful  
15 tool for Forest City over the past 25 years. In the  
16 over-the-counter market we're able to effectively  
17 protect the cash flows of the property as over-the-  
18 counter products allow for us to match the resets of  
19 our loans.

20                  Additionally, over-the-counter products  
21 allowed for us to have notionals on the hedge match the  
22 anticipated loan balance for the loan. This is

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1 especially important for real estate companies because  
2 our construction deals normally accrete while our  
3 stabilized properties normally have amortization.

4           Last, of upmost importance, many times the  
5 collateral on the derivative in the over-the-counter  
6 market is secured by the property rather than cash.  
7 Because the only cash flow on the property are rental  
8 income streams, which is received over time, we do not  
9 have excess cash available at any point in time to sit  
10 in margin accounts.

11           In the event the borrower ceases to be able  
12 to - - be able to make its payments on the loan, the  
13 lender would be able to recoup its losses on both the  
14 loan and the swap through the value of the property. To  
15 the extent the building value had diminished so  
16 substantially that it ceases to be able to cover the  
17 lender's losses on the loan and swap, the lender's  
18 losses would be no more than the losses that they would  
19 have incurred on a comparable fixed rate financing.

20           How do we ensure that we get the most  
21 efficient pricing in the over-the-counter markets? Many  
22 times, in order to get the best price and maintain

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1 transparency, we conduct competitive auctions amongst a  
2 group of swap dealer counterparties who are all  
3 important bank relationships. This is important to  
4 note because we look at the overall cost of our capital  
5 and the overall lending liquidity -- lender liquidity  
6 pool of which derivatives are only one component.

7           To avoid surprises after the trade is  
8 completed, both parties agree on key transaction terms  
9 pre-trade using pre-trade transaction term sheets.  
10 However, actual trade documentation is not completed  
11 until post-trade and only with the winning bank, a  
12 sequence that maximizes bank participation in auctions  
13 by minimizing the pre-trade documentation burden.

14           While many Dodd-Frank rules have yet to take  
15 effect, I would be remiss if I didn't point out that  
16 certain documentation rules that have been discussed  
17 could discourage competition in transparency by  
18 increasing the burden of participation for bidding  
19 banks. Anticipatory compliance with such rules has  
20 resulted in higher costs to us and, in some cases, has  
21 created difficulty in finding counterparties willing to  
22 trade with us, problems we anticipate will increase

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1 once swap documentation rules become effective.

2           Given the situation, many of you might  
3 suggest that we simply move into the futures market  
4 since the market is more transparent and  
5 straightforward. However, given the nature of our  
6 business, our derivatives available in the future  
7 market would not fit in with the structure of our  
8 financings, creating basis risk, accounting problems  
9 and liquidity issues.

10           There are four main reasons for this. First,  
11 the inability to use property as capital on exchanges.  
12 For the vast majority of our interest rate swaps, the  
13 swap is secured by the real estate, just as the loan  
14 is. Exchanges cannot accommodate real estate assets as  
15 collateral. And, most importantly, our lenders have  
16 requirements within their documents that we are not  
17 allowed to have any other kind of subordinated  
18 financing, such as posting cash, taking any --  
19 something out of, you know, the lender's ability to get  
20 their money back on the -- their swap and the real  
21 estate, should something happen to either.

22           Second, futures require initial margins,

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1 something we do not post today. Assuming there was a 3  
2 percent initial margin requirement in lieu of the  
3 structure that exists today and has been grandfathered  
4 in by using real estate, this could have resulted in  
5 collateral posting of \$48 million as of our most recent  
6 quarter of hedges that were outstanding.

7 Third, exchanges in central clearing require  
8 variation margins. As of our most recent quarter end,  
9 if all of our swaps were -- sorry -- required to post  
10 cash, it would have resulted of us posting an  
11 additional \$180 million, which would bring the total  
12 amount of cash required to be posted to be almost \$230  
13 million. This would have been an extraordinary use of  
14 our cash, since as of last quarter, we only had \$214  
15 million available on our credit facilities that is used  
16 to fund the entire operations of the company.

17 To be clear, as a real estate company, our  
18 core area of business is the management, ownership,  
19 development of real estate. Hedges are not the main  
20 component. And therefore, we can't have our cash  
21 availability potentially tied to a non-core need.

22 Last, the futures markets do not accommodate

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1 the customization needs required to perfectly address  
2 our risks. So taking these factors into consideration,  
3 the question is, whether the over-the-counter markets  
4 are no longer cost effective or if there are not enough  
5 counterparties who are willing to participate, will a  
6 company like Forest City end up leaving the over-the-  
7 counter market and move into the futures market?

8           This is unlikely for the reasons that I've  
9 cited today. What this ultimately means for a borrower  
10 like Forest City is to go into higher cost fixed-rate  
11 financing or leave our floating rate debt unhedged.  
12 This results in a loss of transparency, loss of  
13 flexibility and increased risk to non-financial end  
14 users like us.

15           I, therefore, urge you to take into account  
16 the need of end users when designing requirements like  
17 capital and margin requirements that could -- that  
18 could already adversely affect and impact our end user  
19 ability to utilize the over-the-counter derivative  
20 market.

21           I thank you again for allowing me to speak on  
22 behalf of non-financial end users who are simply using

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1 derivatives to mitigate fluctuations to risk.

2 MR. CAMPBELL: Well, thank you. And I want  
3 to thank the Commission for the opportunity to be here  
4 today to discuss this important topic that impacts  
5 energy markets and energy companies like Exelon. Exelon  
6 is one of the leading companies in the physical  
7 commodities space. Exelon is the number one  
8 competitive power generator in the nation and owns  
9 nearly 35,000 megawatts of generation assets.

10 Exelon, through its Constellation brand,  
11 serves physical commodity needs of approximately  
12 100,000 business and public sector companies and  
13 customers, including two-thirds of the Fortune 100.  
14 Exelon also serves approximately one million  
15 residential customers, their electricity and natural  
16 gas needs.

17 As an end user, Exelon actively participates  
18 in the futures and swaps markets to hedge and manage  
19 risks related to this physical portfolio. The  
20 substantial majority of the company's hedging activity  
21 is conducted in cleared markets, in particular, on ICE  
22 and on NYMEX and often originated through voice

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1 brokers.

2           Prior to 2012, these hedging activities were  
3 mostly in swaps. But starting with the ICE transition  
4 in October, these hedging activities are now conducted  
5 mostly in futures. The switch to futures has been  
6 relatively seamless from Exelon's standpoint as an end  
7 user. For the most part, little has changed in day-to-  
8 day hedging operations.

9           The transition to futures, however, has had  
10 one material insignificant impact on our business and  
11 that is in the area of compliance. Exelon is committed  
12 to having a reputation for excellence in compliance and  
13 compliance is a critical component of every business  
14 decision the company makes.

15           In the energy sector, and in particular, in  
16 the context of Dodd-Frank, many of the standards for  
17 compliance are subjective, qualitative and oftentimes  
18 confusing. However, the transition to futures has  
19 provided a refreshing source of compliance clarity.  
20 Rules relating to futures are mature. They're well  
21 understood and developed and, therefore, present  
22 minimal incremental hurdles to navigate.



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1           This clarity is invaluable to those  
2 transacting in the market, for company leadership  
3 trying to make long-term decisions and for people like  
4 me, who are responsible for providing legal and  
5 regulatory advice to these stakeholders.

6           Furthermore, the benefit of compliance  
7 clarity that futurization brings has come with minimal  
8 costs to energy market participants, while also  
9 satisfying many of the key goals of financial reform.  
10 Futures markets have longstanding and robust oversight  
11 by this Commission. Futures markets are centrally  
12 cleared.

13           And from a transparency standpoint, including  
14 pre-trade transparency, and in particular with energy  
15 markets, where -- and power markets in particular,  
16 where many products are thinly-traded, futures markets  
17 arguably provide more and certainly not less  
18 transparency than if they were transacted as swaps.

19           Liquidity is the key element to transparency.  
20 And one needs to ask, at least from the context of  
21 energy markets, many of which are thinly traded,  
22 whether futurization has broken anything that needs to

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1 be fixed. It is difficult to regulate liquidity into a  
2 market but it is very easy for regulation to take  
3 liquidity out of the market. Thank you.

4 MR. DEAS: Thank you. I am Tom Deas, Vice  
5 President and Treasurer of FMC Corporation. We are a  
6 global chemical company. We are on the ground in two  
7 dozen countries making and producing a broad range of  
8 agricultural specialty and industrial chemicals.

9 One of those product lines is soda ash, the  
10 principal ingredient in glass manufacturing -- and for  
11 other uses. We are the world's largest producer of  
12 natural soda ash, and we'd like to think we're a real  
13 export success story. We operate in Southwestern  
14 Wyoming where we are one of that state's largest  
15 employers.

16 We can make soda ash, ship it to South Asia,  
17 and bump Chinese synthetically produced product back  
18 into China with a higher quality and lower cost  
19 product.

20 We do this in part because of our ability to  
21 predict and control our cost, and to do that at this  
22 facility in Southwestern Wyoming, we use flexible,

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1 over-the-counter derivatives to hedge natural gas  
2 exposure.

3           We do not use futures contracts, and I'll  
4 describe in a minute the advantages we see from over-  
5 the-counter derivative use and how we'd like the  
6 commission to continue advocacy of that as an  
7 alternative that's available to end users like FMC.

8           We use calendar year strips to hedge our  
9 natural gas exposure. We are going out two years, and  
10 sometimes farther. We average in -- not trying to time  
11 or guess the market -- but by layering in a series of  
12 calendar year strips for the future on a periodic  
13 basis.

14           We are able to do this between the underlying  
15 exposure on the main index and with basis swaps, with a  
16 few dozen over-the-counter derivative trades. They are  
17 all done under ISDA master agreements with one of the  
18 syndicates of banks that are also providing us in total  
19 with a billion and a half dollars of committed credit.  
20 And there is a legal right of offset that helps us  
21 manage the credit exposure that we have on the  
22 derivative trade with the amounts that we've borrowed

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1 from these banks under this credit agreement.

2           We're an "A" rated company. We have no  
3 credit support annex or other commitment requirement to  
4 pay margin. We are doing uncleared, over-the-counter  
5 derivatives, just like we always did, and we hope we  
6 are going to do those in the future.

7           We support the Commission's interpretation of  
8 the margining requirement under Dodd-Frank and we would  
9 absolutely urge you to continue your efforts to resolve  
10 this big uncertainty for end users with the prudential  
11 regulators and try to assure that we can continue to  
12 use this flexible product to manage our costs.

13           One of the advantages we get from using over-  
14 the-counter derivatives is that the futures market --  
15 because of the way transactions need to be stacked in  
16 that market instead of being negotiated on a strip  
17 basis with an over-the-counter derivative -- would  
18 cause us to enter into at least 12 times more  
19 transactions to hedge a year's exposure.

20           Moreover, because of the margining  
21 requirement under a futures contract, we'd have, let's  
22 say, another 250 transactions. When you multiply that

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1 transaction flow out you get -- here's numbers to  
2 contrast -- in over-the-counter derivatives, we can  
3 complete the hedging program through the execution of  
4 about 100 transactions, and with the futures  
5 equivalent, it would be 144,000 transactions.

6           And so, as an end user, not involved in the  
7 energy space, other than to hedge this component of our  
8 input costs, of our productions costs -- we are not  
9 operating a trading room, and we don't have the back  
10 room facilities to be able to handle that huge -- more  
11 than a thousand fold increase in the transaction volume  
12 that a move to the futures market would require of us.

13           So, just to summarize, over-the-counter  
14 derivatives for us provide significantly lower  
15 transaction intensity than the futures equivalent.  
16 There is much greater liquidity by trading an entire  
17 calendar year strip for us than the futures alternative  
18 in some months that may be out at the end of time  
19 horizon of our hedging program.

20           We have a much greater ability with over-the-  
21 counter derivatives to make adjustments. One of the  
22 reasons that the over-the-counter derivatives market

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1 grew to be the largest financial market in the world  
2 was its ability to customize and allow end users like  
3 us exactly to match the underlying exposure with a  
4 derivative attuned to that exposure in terms of amount,  
5 currency, tenure -- all of the other components -- and  
6 that's not available to us in all instances in the  
7 sometimes one size fits all futures market.

8               So, again, I would just appreciate the  
9 Commission's effort to do everything you can to  
10 maintain over-the-counter derivatives as a viable  
11 alternative, not to burden them with margin  
12 requirements or other impediments that would take this  
13 alternative away from us.

14               Thank you.

15               MR. KOTSCHWAR: Good afternoon. I'm Lance  
16 Kotschwar with Gavilon. I'm here on behalf of the  
17 Commodity Markets Council. Thank you for the  
18 opportunity.

19               I want to specifically address the two  
20 questions that you had us consider today, Abigail, but  
21 before I do that I wanted to just talk a little  
22 generally about Dodd- Frank.

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1           We agree with the primary goals of Dodd-  
2 Frank, which is to reduce the systemic risks through  
3 centralized clearing, increasing transparency through  
4 reporting and trading unregulated platforms where  
5 applicable.

6           And we also agree with Congress that futures  
7 and swaps should be regulated appropriately and that  
8 regulation for swaps should be different than futures  
9 because they are different things.

10           Not all swaps must be traded on exchanges or  
11 cleared, because commercial should be able to enter  
12 into swaps but not futures, over-the-counter, as they  
13 do today to hedge risks.

14           As commercial end users and other market  
15 participants, we need the most efficient and  
16 effective markets to manage our risks, including  
17 both listed futures and over-the-counter products. Our  
18 businesses depend on the price discovery and the  
19 liquidity of futures markets, and we also rely on the  
20 ability to use customized swaps as well.

21           So we don't think it's quite accurate to say  
22 that there's disparate regulatory treatment between

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1 futures over swaps. We think there are underlying  
2 reasons for that that are legitimate and make sense.

3           Many of the new swap regulations are similar  
4 to the regulations that have historically been imposed  
5 on futures markets, but they also reflect key  
6 differences and two primary factors drive that, I  
7 think.

8           There are different risk characteristics  
9 between futures and swaps, and then there is just a  
10 different trading manner. Futures traditionally are  
11 standardized. They trade centrally on DCM's. Swaps  
12 have historically been more customized and traded  
13 bilaterally in over-the-counter dealer markets.

14           The margin requirements for futures and swaps  
15 are another example of traditional expectation  
16 regarding the relative standardization of products held  
17 in futures portfolios versus the more customized nature  
18 of products held in swap portfolios.

19           And also, another example is flexibility and  
20 execution afforded to swaps via SEFs versus  
21 customized products because they don't lend themselves  
22 well to trading in centralized markets.



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1           As market participants, we will continue to  
2 consider whether a customized or standard product will  
3 serve our needs best. Regulatory treatment of futures  
4 versus swaps will be a part of that calculation, and  
5 the fact that firms are making these trading decisions  
6 based on this kind of assessment does not mean that  
7 swap markets have been unfairly disadvantaged. We will  
8 continue to use them both to serve our risk management  
9 needs the best way we can. Innovation and competition  
10 and customer choice among well regulated markets is  
11 important to us.

12           I want to get specifically to the two  
13 questions that we were directed to today. Question #1:  
14 "In light of ICE's and CME's listing of energy swap  
15 contracts as futures contracts, which coincided with  
16 the October 20, '12 effective date of the swaps rules,  
17 what issues or challenges would you like to bring to  
18 the attention of the Commission?"

19           We do not have any issues or challenges we  
20 would like to bring to your attention other than to say  
21 that we appreciate the Exchange's responsiveness to the  
22 requests of their customers.

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1           We would, however, like to make an  
2 observation that from our perspective the big driver of  
3 what ICE and CME did in October was really the result  
4 of one thing, regulatory certainty, something that Lael  
5 said earlier.

6           On October 12th, many Dodd-Frank rules began  
7 to go into effect. The problem is that there was then,  
8 and still remains, a tremendous amount of uncertainty  
9 around the swap regulation regime. And futures  
10 regulation is something we all are familiar with and  
11 comfortable with, and certainly in the short term it  
12 provides our compliance staff with significantly more  
13 comfort. Again, that's something that Lael said.

14           The second question: "Are there any issues  
15 or challenges that should be addressed regarding  
16 consistency between swaps and futures regulations,  
17 whether in one of the remaining rulemakings, or  
18 something that has already been put out?"

19           As I've discussed, I think there are  
20 legitimate reasons for treating swaps and futures  
21 differently, owing to the differences between the  
22 instruments. We believe that futures instruments have

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1   been, and are currently being regulated in an  
2   appropriate manner.

3               However, with respect to the regulation of  
4   swaps, I think it is a fair question to ask whether all  
5   of the recently promulgated rules, and still pending  
6   rules applicable to swaps and swap dealers, are  
7   appropriate.

8               But just to wind up here, from our  
9   perspective - - you know, the thesis of the derivative  
10   title of Dodd- Frank was the appropriate regulation of  
11   swaps, not regulatory parity between swaps and futures,  
12   whatever parity means in that context.

13              And lastly, I know you tried to keep block  
14   trading confined to one panel, but in keeping with  
15   everybody wanting to throw in a gratuitous remark about  
16   block trading, I just wanted to bring one more  
17   perspective to it.

18              It's been said, but I just want to say it in  
19   maybe a different way. You know, Dodd-Frank envisioned  
20   a structure where swaps can trade across multiple  
21   trading venues, unlike futures where a futures contract  
22   is generally a proprietary to the exchange where it's

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1   traded.

2                   So with this distinction it makes some sense  
3   that some entity other than the trading platform,  
4   whether it's a SEF or a DCM, would aggregate the  
5   liquidity of the instrument across trading venues and  
6   set it in an appropriate block threshold. And there's  
7   no individual trading venue that's going to have a full  
8   view of all that liquidity.

9                   But that is not how it works on the DCM  
10   because you've got all of the liquidity right there in  
11   one place, so we think in that sense it makes sense for  
12   the DCM to continue to be able to evaluate and  
13   determine block levels at that level. And again, in  
14   keeping with my theme here, "if it ain't broke, don't  
15   fix it," and it seems like the DCM approach to this is  
16   working very well.

17                  Thank you.

18                  MR. ZUBROD: Good afternoon, and thank you  
19   for the opportunity to offer an end user perspective on  
20   futurization. My name is Luke Zubrod and I am Director  
21   of Risk and Regulatory Advisory Services at Chatham  
22   Financial. Having introduced Chatham on a prior panel,

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1 I will transition directly to my comments.

2           On the last panel I focused my comments on  
3 concerns relevant to financial entity hedgers. On this  
4 panel I'll focus on those concerns applicable to non-  
5 financial end users.

6           The topic of futurization is an important one  
7 for end users. End users specifically, and hedgers  
8 more broadly, have long valued over-the-counter  
9 derivatives because of the ability to customize them,  
10 to perfectly mitigate a company's idiosyncratic risks,  
11 and because of the ability to bilaterally negotiate  
12 margin arrangements with swap dealer counterparties.

13           Regulatory actions that create an incentive  
14 for end users to clear their trades or use futures  
15 would have at least three adverse consequences, two of  
16 which I mentioned on the prior panel.

17           Basis risk is one of those. Regulatory  
18 incentives that encourage futures would cause companies  
19 to take on basis risk, that is, mismatches between the  
20 hedge and the risk that hedge is designed to address.

21           Basis risk poses a threat of loss for end  
22 users, and that's especially true in times of market

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1 stress.

2           Basis risk also leads to the second adverse  
3 consequence, which is accounting and effectiveness.  
4 Basis risk is reflected in financial statements as  
5 accounting and effectiveness and because accounting and  
6 effectiveness, and the income statement volatility it  
7 creates, it's difficult or impossible to control.  
8 Public companies often avoid hedging strategies that  
9 might result in effectiveness.

10           The third issue -- and this is particularly  
11 pertinent to non financial end users -- is liquidity  
12 risk. End users appreciate uncleared, over-the-counter  
13 derivatives, because they afford the ability to  
14 transact in a manner that does not require the posting  
15 of initial or variation margin.

16           Cleared swaps and futures trades, on the  
17 other hand, are fully margined. Because margin  
18 requirements create an unwelcome liquidity risk for end  
19 users, many end users will accept higher costs on  
20 uncleared, over-the-counter derivatives, in order to  
21 avoid the liquidity burden created by fully margined  
22 products.

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1           I would like to identify two areas in which  
2 regulators can ensure its proposals do not adversely  
3 impact end users by driving up costs or by introducing  
4 new risks.

5           One, initial margin. Although non-financial  
6 end users are not directly subject to initial margin  
7 requirements in the CFTC's proposed margin rule, their  
8 swap dealer counterparties are subject to such rules.  
9 Because dealers typically offset their positions to end  
10 users, the dealer must post initial margin on positions  
11 used to offset end user hedges.

12           Because these initial margins are incurred  
13 solely to facilitate the end users trades, the swap  
14 dealer will increase the transaction price paid by the  
15 end user to compensate it for what would otherwise be  
16 an unproductive use of its funds.

17           The higher transaction price that results  
18 creates a regulatory incentive for end users to  
19 consider using futures, an incentive that brings with  
20 it the aforementioned adverse consequences of basis  
21 risk accounting and effectiveness and liquidity risk.

22           Capital requirements. Similar to initial

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1 margin requirements, capital requirements applicable to  
2 swap dealers against trades executed with end users  
3 will cause dealers to increase end user transaction  
4 prices for uncleared swaps.

5           Higher pricing on uncleared swaps will create  
6 regulatory incentives for end users to consider  
7 clearing, even though they are technically eligible for  
8 the end user exception.

9           Margin differences between cleared swaps and  
10 futures will further cause end users to consider using  
11 futures, however, because of countervailing business  
12 incentives created by basis risk, accounting and  
13 effectiveness and liquidity risk, many end users will  
14 opt not to use cleared swaps and futures.

15           The net result for such end users will be  
16 higher costs that could deter some users from hedging,  
17 or make hedging more expensive.

18           Limiting or eliminating initial margin and  
19 capital requirements applied to swap dealers when their  
20 transactions are executed in connection with end user  
21 hedging transactions would serve to lower end user  
22 costs and avoid a deterrent to hedging. Regulators



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1 should consider such relief because end user hedging  
2 activity does not meaningfully contribute to systemic  
3 risk.

4           On this basis, Congress established an end  
5 user exemption. Please don't take that exemption away  
6 by making uncleared, over-the-counter derivatives, too  
7 expensive to use.

8           Thank you.

9           MR. FRENK: Thanks. I'm David Frenk, the  
10 Research Director at Better Markets. We are a  
11 501(c)(3) nonprofit. I think you are all familiar with  
12 us. We aim to represent the public interest in the  
13 capital and commodity markets.

14           Most of us, myself included, used to work in  
15 finance -- don't anymore -- which gives us the unique  
16 opportunity to be on the one hand informed and on the  
17 other hand impartial.

18           We appreciate the opportunity to come here  
19 today and talk about futurization, although perhaps it  
20 would be better titled, "Re-futurization," since for a  
21 century or so, if you were an end users looking to  
22 hedge, futures were your option.

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1           We had a brief experiment with the over-the-  
2 counter markets. You could say a 30-year experiment,  
3 or if you time it from CFMA, about an eight year  
4 experiment, which was kind of a miserable failure given  
5 that we nearly blew up the world, but then Congress  
6 decided to go back to the drawing board and see if we  
7 could sort of capture the best of both worlds.

8           They said, "Well, should we throw out OTC  
9 swaps entirely?" No, the end user still wants some  
10 degree of customization.

11           Okay. So how can we fit that into a  
12 structure that's not going to run the same risk that we  
13 had with pure OTC? They said, "Okay, you can keep  
14 customization, but you're going to have to execute  
15 these things on a SEF. You're going to have to clear  
16 them, unless you are somehow insulating this from the  
17 financial sector as a whole; i.e. by doing it end-user  
18 to end-user that would give you an end-user exemption."

19           Similarly, if there is something that is so  
20 exotic that doing it through clearing and trading would  
21 cause a systemic problem within the primary market, you  
22 can also do that on the side so it doesn't blow

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1 everything up.

2           Okay. Great. So then you've got the IDBs,  
3 and they say, "Fantastic. We'll become SEFs. We have  
4 a three hundred trillion dollar pie here that's been,  
5 you know, baked up the dealers and now served up by  
6 Congress and we want a slice, except now we have a  
7 problem because the pie seems to be getting smaller,  
8 since, you now, a lot of it is starting to be served  
9 chez ICE and chez  
10 CME."

11           And so the question I think we've got to be  
12 asking here from the public interest perspective, from  
13 a regulatory perspective, is why is the pie shrinking?  
14 Is it simply because there is some sort of regulatory  
15 loophole when it comes to futures? And sure enough, I  
16 think plenty of people have identified the fertile  
17 areas to be looking in that regard -- block trades,  
18 core principle 9.

19           You know, is it simply the case that yes, the  
20 futures -- the DCM's have been in this game for a long  
21 time, but the game has now changed, and so what once  
22 worked, letting these guys decide a lot of their own

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1 rules, may no longer be appropriate now that the stakes  
2 have become so much higher. These are issues that the  
3 Commission needs to be looking into.

4           On the flip side though, there are clearly  
5 other things going on here and I would say that re-  
6 futurization is actually clear evidence that end users  
7 had other reasons for trading on the OTC markets beyond  
8 the availability of customization.

9           So what could those reasons be? Well, if I'm  
10 and end user using OTC, other than customization, what  
11 were the perceived advantages I may have had?

12           Number one, no margin. You know, you wonder,  
13 what are the biggest charities in the world? You might  
14 think Oxfam, Action 8, and so on. Apparently, it's  
15 actually Goldman Sachs, J.P. Morgan, because if you  
16 believe the figures, they gave out about a trillion  
17 dollars of free hedges to the end user community by not  
18 charging a margin, which is very generous.

19           Of course, we know that -- and I should just  
20 say that I don't necessarily agree with the trillion  
21 dollar figure, right -- maybe the Bank of England, \$200  
22 billion, is more appropriate -- but whatever figure you

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1 want to put on it, we all know that that wasn't given  
2 away for free.

3           You know, credit charges were imbedded in the  
4 prices of swaps and so -- okay, maybe I didn't have to  
5 pay margin and maybe I had cash freed up in some way as  
6 a result of that, but you know, that cash was probably  
7 not just being given to me for free, it was costing me  
8 in other areas -- in the price of my swaps, in other  
9 words.

10           Okay. So that's one thing, there's the no  
11 margin issue, and then the other thing -- well, I had  
12 opacity. Okay. So that gave me a lot more flexibility  
13 when it came to my balance sheet. You might say too  
14 much flexibility. We all know some pretty good  
15 examples of end users who were doing some pretty  
16 terrible things with that flexibility.

17           Either way you look at it though, Dodd-Frank  
18 came in and said, "Okay, sorry, those two advantages,  
19 they don't exist anymore. We're not going to have  
20 improper risk management. We're not going to have  
21 opacity anymore."

22           That's part of the law now that that doesn't

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1 exist, so you've lost a couple of things as an end  
2 user. You've lost the ability to cook your books by  
3 using OTC derivatives. You've lost the privilege of  
4 funding Lloyd Blankfein's bonus by paying him better  
5 credit charges than your swaps.

6 But on the other hand, you know, you've  
7 gained quite a lot of things, right? I mean, you've  
8 basically gained competitive pricing and more  
9 transparency.

10 You do have the best of both worlds, and in  
11 fact that was exactly what was intended and exactly  
12 what the Commission is trying to put into place here.  
13 You can still customize, you just have to pay the  
14 appropriate prices and, you know, from our perspective  
15 -- from the public interest perspective, and I think  
16 realistically from the end user perspective, that's a  
17 pretty good tradeoff.

18 MR. CAMPBELL: I want to thank you again for  
19 the opportunity to speak on two panels, and I'll try to  
20 take a different tact on the points I'm going to  
21 address today.

22 I think a number of the technical issues have

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1 already been addressed by the folks to my right. You  
2 know, the appeal of a free hedge. It makes me think of  
3 a free lunch. I didn't have to pay for lunch today,  
4 but somehow or another I'll pay for it in the end, I'm  
5 sure, so I don't think that ever exists.

6           The perspective maybe I can try to bring is  
7 this. I've been with Deloitte for almost fifteen years  
8 - - and it's part of the same practice -- and so I have  
9 some sense of trends that have moved through the energy  
10 markets as they've deregulated, as they've been  
11 actively traded, thinly traded, both on the large  
12 trading, large operators, all the way down to small  
13 operators -- small, even special entities.

14           And some of the trends that have come through  
15 -- and maybe that'll help maybe to point towards some  
16 of the issues I think that the Commission could be  
17 addressing here.

18           If I look at Title VII, and just the Title  
19 VII aspects of Dodd-Frank, it feels very similar -- and  
20 I use the analogy a lot when I'm working with clients  
21 on solving problems -- if you're familiar with the  
22 hedge accounting rules that came out of the early part

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1 of the 2000 -- so it's really around FAS 133 and how  
2 those evolved into ASC 815.

3           The hedge accounting rule actually feels a  
4 lot like this where we went through this period of we  
5 had -- you know, what I've described as maybe rules  
6 were written for large financial entities and then they  
7 made their way down to the end users, to energy  
8 companies -- and it was a number of years before we got  
9 to good interpretation and guidance in terms of how  
10 those should be implemented.

11           It feels very similar to that in terms of the  
12 time it's taking to work through this, as well as the -  
13 - I would say lack of preparation, or readiness, on  
14 behalf of the energy companies -- they struggled with  
15 that for a number of years.

16           We saw that from Deloitte's perspective, both  
17 as an auditor as well as a consultant, and I'll say  
18 that the same issues and the things I'm going to talk  
19 about feel very similar to that.

20           So, the perspective we're bringing in is  
21 we're on the ground with a wide range of clients across  
22 North America trying to implement these rules, and as



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1 it gets to specifically the swaps and futurization --  
2 you know, the thoughts we have are, do we have to build  
3 a new system for this? Do we have to build a new  
4 process? Do we have to build a customized tool? Can  
5 we get this done in Excel? How do we do this -- and,  
6 you know, to come back to what Lael said -- how do we  
7 make sure companies are complying and help them do  
8 that? And how do we do that as efficiently as  
9 possible?

10           And so the move from swaps to futures I would  
11 say has been incredibly efficient. In terms of a  
12 compliance requirement, it's been very beneficial to  
13 most energy companies.

14           I'll try to talk about some of the exceptions  
15 as well as maybe some of the unintended consequences  
16 that I could see potentially coming out of that. I  
17 would refer back to, again, as I think about the broad  
18 market, and not just talking about the market as a  
19 whole, but really the segmentation within that.

20           So not the swap dealers and how they'll all  
21 be effected by this, and maybe not even the large  
22 trading companies that are kind of these -- the

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1   tweeners -- nor the companies that have just now, I'd  
2   say, moved away from anything to do with swaps  
3   whatsoever, but the companies that fall into that other  
4   category. And this, I'd say, solely hits the end  
5   users, mid-size utilities, anybody in the energy space  
6   that hedges in a variety of different ways, but  
7   sometimes intermittently.

8                   And I think the first thing to do is look at  
9   the period of time we're dealing with, and from an  
10  economic standpoint, you know, we're dealing with  
11  incredibly low gas prices on a historic level,  
12  volatility is as low as it's been in a while, and so as  
13  we think about these issues and the problems they may  
14  be creating for people by not having liquidity in a  
15  cleared market -- or an uncleared market -- were  
16  thinking about that because people actually aren't  
17  hedging very actively right now.

18                   If we were having this conversation four  
19  years ago when gas prices were moving at eight and nine  
20  dollars -- the call that it's going to put on liquidity  
21  -- what that would do to margin, and frankly, just  
22  people to be willing to enter the market -- it would be

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1 a very different story.

2 I don't know when gas prices are going back  
3 up. You know, we could poll maybe some of the other  
4 people on the panel. They certainly probably have a  
5 view on when they will or when they'd like them to go -  
6 - probably sooner rather than later -- but I'm quite  
7 sure they are going to go back up, and I would expect  
8 commodity prices, besides what we've seen in the ag  
9 space, on the power side, also to ramp up.

10 It's a normal, mean reverting process, and so  
11 I'd expect to see a return to high gas prices, high  
12 power prices, at some point in the future.

13 And then you're going to have these companies  
14 that have been sitting on the sidelines, not having to  
15 actively hedge, reenter the market. And it's when they  
16 reenter the market that that's when we tend to see, I  
17 would say, discontinuity in their ability to actively  
18 manage their risk.

19 And so as I think about the unintended  
20 consequences of this, it's the people that are making  
21 those markets for them and going away and moving to a  
22 cleared environment, and then not being able to provide

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1 products to people, I think that's a real risk that  
2 maybe we're overlooking right now.

3           And so maybe that's two years down the line,  
4 maybe that's three years down the line, maybe it's this  
5 summer if we get a big hurricane going through the  
6 Gulf. It's hard to predict when these things are going  
7 to happen, but I feel relatively comfortable in saying  
8 that it likely will happen again.

9           And so -- I think it was Tom Farley, on the  
10 previous panel, who said, you know, give this some time  
11 to think how it's going to move through, to understand  
12 really what all of the changes are going to be before  
13 maybe passing further rules.

14           I think providing the opportunity to keep an  
15 uncleared swap market out there, as well as the  
16 participants in that -- from the brokers all the way  
17 down -- I think is a vital piece of that because when  
18 you are dealing with people that have operational risks  
19 that are tied to, you know, their liquids production --  
20 their liquids processing -- there's a very limited  
21 number of people that can actually participate in that  
22 market.

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1           And the people that are willing to provide  
2 very tailored, small lot products to end users -- there  
3 aren't a lot of people that can step into that -- and  
4 so if the market for that goes away in the uncleared  
5 swap business, I think you could actually have some,  
6 again -- the unintended consequences of people not  
7 being able to manage their risk. I really view that as  
8 a significant concern.

9           The other one is -- because there has not  
10 been a lot of pressure to hedge because commodity  
11 prices have been low -- if you look at the state  
12 commissions, they have not been pushing the utilities  
13 that are still regulated to put in hedging plans around  
14 their gas purchases -- I would say most companies  
15 actually don't have a lot of experience in managing  
16 liquidity, and managing liquidity risk, and so they'll  
17 be fairly comfortable entering a futures market now --  
18 or a future swap market now -- because it's not putting  
19 a lot of burden on them.

20           But if you move back to where volatility is  
21 moving at 50% or 100% in a gas or power market, and  
22 suddenly they have to start managing it, most of them

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1 don't have the adequate processes or systems in place  
2 to manage that.

3           And so again, that's an issue that isn't  
4 going to -- I'll say -- pop up today, but something  
5 that's going to pop up in a year or two, and then I  
6 would say again, create that issue for the people that  
7 are actually just trying to manage their risk.

8           I think those are really -- probably, you  
9 know -- really serious things. They're not going to  
10 happen next month, but I could see them coming up in a  
11 year or two, and I'd be fairly concerned with that.

12           You know, the last -- and I think Luke  
13 touched on it -- we were talking at the break about  
14 this -- as it comes to providing more guidance to them,  
15 for the larger companies, they are sophisticated enough  
16 that they have the resources to put in implementation  
17 plans in to ensure in compliance.

18           For the smaller ones, they're -- I'll say --  
19 very much struggling with this, both from awareness  
20 standpoint, as well as just having the tools to do it.  
21 I was telling Luke, you know, we built kind of a quick  
22 start methodology -- it's almost a Dodd-Frank in a box

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1 to give to smaller clients -- so they could do it on an  
2 affordable basis.

3 To the extent you can provide more clarity,  
4 specifically around the swaps and futures in what's in  
5 and what's not, and how the they'll manage the  
6 uncleared environment, I think that would be very  
7 helpful to see from the Commission.

8 Thank you.

9 MR. SHILTS: Okay. Thank you all. I don't,  
10 myself, have any questions. Does anyone else here have  
11 any questions you want to ask? I think the issues and  
12 concerns were expressed pretty clearly, and it's been a  
13 long day.

14 Commissioner O'Malia? Chairman Gensler? Do  
15 you have any questions you want to ask of the panel  
16 before we adjourn?

17 All right. Does anyone else have any further  
18 comments they want to make before we adjourn for the  
19 day? Any of the panelists?

20 All right. With that, then I want to thank  
21 everyone. I appreciate you sticking with us for an  
22 extra hour as we went over, but the discussions were

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1 very interesting, and it's always nice to have a lot of  
2 people wanting to participate and then having a lot to  
3 say, and it's been very productive.

4           So, again, thanks everyone, and with that, I  
5 think we will conclude the roundtable for today.

6           (Whereupon, at approximately 3:59 pm, the  
7 above- referenced meeting of the Commodity  
8 Future Trading Commission was adjourned.)

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11 \_\_\_\_\_ AnnMarie Wasko

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