

1 CFTC Market Risk Advisory Committee (MRAC)

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12 Tuesday, December 4, 2018

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15 Commodity Futures Trading Commission (CFTC)

16 Three Lafayette Centre

17 Conference Center

18 1155 21st Street, NW

19 Washington, D.C. 20581

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

2 (9:34 a.m.)

3 Welcome and Opening Remarks

4 MS. LEWIS: Ladies and gentlemen, can you
5 please take your seats?

6 Good morning. As the MRAC-Designated Federal
7 Officer and Acting Chair of this committee, it's my
8 pleasure to call this meeting to order.

9 COMMISSIONER BEHNAM: I'm going to take a
10 quick second to acknowledge the Chairman to make some
11 remarks before we begin the regular order of business.

12 CHAIRMAN GIANCARLO: Thank you. As we all
13 know, we lost a great American leader over the weekend.
14 George Herbert Walker Bush was the President of the
15 United States and a great leader who served in war
16 time, on his 18th birthday enlisted in military service
17 and served with distinction, became an entrepreneur and
18 then entered into a lifetime of public service as a
19 congressman, as the head of the CIA, as an American
20 Ambassador to the United Nations and to China, and also
21 as Vice President for two terms and President of the
22 United States.

1 He entered into service not to exert power
2 over the lives of others but to serve the lives of
3 others. In his memory, the Federal Government will be
4 closed tomorrow. This agency will be closed. Many of
5 our markets will be closed and we will just have a
6 small staff to provide surveillance of the markets that
7 remain open but otherwise we'll be closed.

8 But I'd like to just call us all to just
9 recognize a moment of service for the loss of an
10 American leader, if we can.

11 (Moment of Silence.)

12 COMMISSIONER BEHNAM: Thank you.

13 MS. LEWIS: Before we begin this morning's
14 discussion, I would like to turn to the members of the
15 Commission for opening remarks. We will start with
16 Commissioner Berkovitz followed by Commissioner Stump,
17 then Chairman Giancarlo, and finally Commissioner
18 Rostin Behnam, the MRAC Sponsor.

19 Commissioner Quintens could not be with us
20 today. However, he sends his regards and his remarks
21 can be found on the Commission's website.

22 Now we will have remarks from Commissioner

1 Berkovitz.

2 COMMISSIONER BERKOVITZ: Thank you. I'd like
3 to thank in advance all of the participants in today's
4 meeting for contributing to the discussion and
5 Commissioner Behnam and Alicia Lewis for sponsoring and
6 putting together this morning's meeting.

7 I want to briefly mention my interest in two
8 topics that will be discussed today: clearinghouse
9 risk management and the treatment of derivatives
10 exposures and margins under credential regulator rules.

11 First, clearinghouse risk generally.
12 Clearinghouse risk management is a critical issue for
13 the CFTC. After the adoption of the Dodd-Frank Act,
14 substantially more activity both in swaps and futures
15 is now centrally cleared.

16 I believe wholeheartedly that encouraging
17 central clearing is good for our markets and market
18 participants. Central clearing mitigates systemic
19 risk. However, with the expansion of the volumes of
20 trades cleared, we need to be ever-more vigilant in
21 monitoring and overseeing clearinghouse risk
22 management.

1 A big part of that effort is having
2 opportunities like this meeting to discuss with market
3 participants the clearing risk management and
4 governance issues on today's agenda.

5 A few words also about the capital treatment
6 for derivatives exposures. During the last public
7 meeting of the Commission, I expressed concern that
8 market concentration and fewer entities can have
9 negative effects on competition and systemic risk.

10 It is well known that FCM services are
11 becoming more and more concentrated. A large majority
12 of futures and swaps are now cleared by a handful of
13 FMCs affiliated with large banks.

14 The document recently released by the FSB on
15 incentives to centrally clear OTC derivatives states
16 that "across the United States, the United Kingdom, and
17 Japan the amount of cleared client trading activity
18 which passes through the top five clearing members
19 exceeds 80 percent for IRS as measured by notional
20 values."

21 The FSB also reports that the current
22 treatment of margins posted by clients and the leverage

1 ratio may be a significant disincentive for FCMs to
2 offer or expand client clearing.

3 I'm very much aware of the concerns around
4 bank leverage and support efforts to restrict excessive
5 risk-taking by banks. However, the reduction in the
6 availability of clearing services offered by fewer
7 firms could itself become a risk issue. This would not
8 be a good outcome.

9 In considering measures to reduce risk in one
10 area, we must ensure that we are not creating or
11 exacerbating risks in another area.

12 Accordingly, I look forward to the discussion
13 today of current proposals by prudential regulators to
14 revise the calculation of derivatives exposures for
15 bank capital rules.

16 Thank you.

17 MS. LEWIS: Thank you, Commissioner
18 Berkovitz.

19 Commissioner Stump.

20 COMMISSIONER STUMP: Good morning. Thank you
21 to Commissioner Behnam and Alicia Lewis and to all of
22 the members of the committee for putting together this

1 very thoughtful program.

2 I also want to commend Commissioner Behnam
3 for his leadership in reviewing the critical transition
4 to the alternative reference rates and I look forward
5 to working with the newly-established Subcommittee on
6 Interest Rate Benchmark Reform.

7 This work is timely and essential to the
8 orderly functioning of our financial markets and I look
9 forward to their work.

10 Additionally, the important role of
11 clearinghouses in our financial system is undeniable
12 and we rely on them and most often I think we as
13 regulators talk about the risks that they help our
14 market participants deal with in the form of
15 counterparty credit risk, but the performance of this
16 fundamental market service is often the subject of our
17 debates and I look forward today to talking a bit more
18 about the clearinghouse infrastructure risk from
19 settlement bank and custodian bank failures to cyber
20 security and the use of third party service providers,
21 what standards guide the management of these risks, and
22 who bears those risks and over what time horizon.

1 I think these are important questions and the
2 Commission needs to be fully briefed and aware of how
3 those things are being managed today and if more needs
4 to be done going forward.

5 I'm also looking forward to continuing our
6 review of our regulatory efforts. You all have
7 probably heard me state that I consider this to be the
8 most critical element of the G20 reforms that we
9 constantly reassess and determine if our regulations
10 are fit for the purpose they were intended.

11 So I look forward to hearing from many of you
12 regarding the recent reports of the global standard-
13 setting bodies and the proposals from other regulators.

14 The topics we discuss today are closely tied
15 to this Commission's mission of fostering open,
16 transparent, competitive, and financially-sound
17 markets.

18 I want to thank all of the presenters today
19 and I look forward to your presentations.

20 MS. LEWIS: Thank you, Commissioner Stump.

21 Chairman Giancarlo.

22 CHAIRMAN GIANCARLO: Thank you very much,

1 Alicia.

2 My thanks to Commissioner Behnam for holding
3 this meeting on these important topics and I also want
4 to thank you, Alicia Lewis, and the Commission staff
5 and presenters that are here today on these panels, and
6 I share Commissioner Stump's recognition of
7 Commissioner Behnam's focus on benchmark reform which
8 is a very, very important topic for all of us.

9 Over the past several years, there's been
10 substantial progress on ensuring the safety and
11 soundness of swap central counterparties, especially on
12 recovery planning. Nevertheless, there is still more
13 to do, in particular on resolution planning.

14 The size and scope and complexity of CCPs has
15 increased as has the importance of effective risk
16 management and governance. It's important that we
17 continue to have an ongoing conversation with CCPs and
18 their members regarding these important issues of risk
19 management and governance and I share Commissioner
20 Berkovitz's concern for concentration of clearing
21 services, indeed other services, as well, in our
22 cleared swaps markets.

1 This MRAC continues to have an important role
2 in facilitating this very important dialogue.

3 The analog-to-digital switch in financial
4 markets happened -- sorry. The changeover to digital
5 in financial markets happened years ago and continues
6 today and the CFTC needs to keep pace with this rapid
7 digitization of our markets.

8 Market participants and registrants have
9 moved away from a bricks and mortar world and are
10 moving towards outsourcing their infrastructure and so
11 it is apt to think about these changes, as well.

12 One of the challenges of regulation in a
13 digital world that's built on registration and direct
14 oversight of market participants and registrants, as
15 more outsourcing of critical components occurs, what
16 does that mean for that model of regulation?

17 It's a timely topic and I thank you for
18 bringing us here today to discuss it further. I look
19 forward to the conversation today.

20 MS. LEWIS: Thank you, Chairman Giancarlo.

21 Commissioner Behnam.

22 COMMISSIONER BEHNAM: Good morning, and

1 welcome to the MRAC's third and final meeting of 2018.

2 As we have edged closer to a new year, I've
3 begun to reflect on the work of this commission that
4 started 12 months ago, and I'm both proud of the
5 accomplishments and equally optimistic and excited for
6 2019.

7 As our markets continue to grow, evolve, and
8 innovate in an atmosphere of increasing geopolitical
9 tensions, there will be new questions and issues to
10 address.

11 This committee continually demonstrates
12 adaptability, to adapt itself by addressing the most
13 pressing and challenging market-risk issues of the day.

14 I want to thank Chairman Giancarlo,
15 Commissioners Stump and Berkovitz for being here today,
16 and for their contributions to this discussion. We
17 have a full day ahead, including the introduction of
18 the newly-formed Interest Rate Benchmark Reform
19 Subcommittee.

20 I wanted to thank and acknowledge the MRAC
21 members who volunteered to moderate the panels today.
22 I also want to thank each of the speakers for their

1 willingness to travel to D.C. through the holiday
2 season and contribute to this important conversation.

3 I want to thank the Commission staff who will
4 be speaking today and some of whom have also traveled
5 to be here, and I'd also like to thank Margie Yates,
6 her team, and all of the Commission staff who worked
7 behind the scenes to make these meetings come alive and
8 run smoothly.

9 Finally, I'd like to thank Alicia Lewis, the
10 committee DFO. Three meetings deep in a short 12
11 months and Alicia keeps core logistics running smoothly
12 and helps formulate and shapes topics, issues, and
13 discussions that make all of the MRAC meetings so
14 valuable and insightful.

15 Today's agenda begins with Tom Wipf, Vice
16 Chairman of Institutional Securities at Morgan Stanley,
17 and our newly-appointed Chairman of the Interest Rate
18 Benchmark Reforms Subcommittee.

19 Thanks in part to Tom's participation, the
20 last meeting of the MRAC in July introduced benchmark
21 reform as a key topic of an interest not only to MRAC
22 members but also to anyone who has a car, a small

1 business loan, student loan, mortgage, or credit card.

2 As highlighted by Chairman Giancarlo in

3 remarks last week at the 2018 Financial Stability

4 Conference, despite huge improvements in the governance

5 process to reduce Libor, the market for unsecured

6 inter-bank long-term lending that underlies Libor has

7 dried up and the regulatory mandate compelling Libor

8 submissions has an expiration date.

9 Fortunately, there are coordinated

10 initiatives underway specifically targeted at

11 addressing the myriad of impending issues related to

12 the derivatives market. Chief among these initiatives

13 is the Alternative Reference Rate Committee which is

14 tasked with leading and directing the transition away

15 from Libor to SOFR, the Secured Overnight Financing

16 Rate.

17 At the MRAC's July meeting, three panelists

18 focused on the role of interest rate benchmarks in the

19 economy, the impetus for Libor reform and the current

20 status of global reform initiatives, the development of

21 SOFR and SOFR derivatives, and the impact of Libor

22 reform on legacy derivatives contract, the development

1 of fallback language, and key-risk management and
2 governance considerations for market participants.

3 Following the meeting, the Commission voted
4 to establish the Interest Rate Benchmark Reform
5 Subcommittee to provide reports and recommendations to
6 the MRAC regarding efforts to transition to U.S. dollar
7 derivatives and related contracts to SOFR and the
8 impact of such transition on the derivatives markets.

9 I was overwhelmed by the number of highly-
10 qualified nominations to the subcommittee and it
11 certainly was difficult to make selections. I strived
12 to ensure that the membership represents the diversity
13 of viewpoints and I believe the final 21 individuals
14 chosen to serve will participate actively and engage
15 one another as they develop and work towards the
16 subcommittee's goals and objectives.

17 Tom will kick off today by reporting on the
18 subcommittee's first initiatives.

19 My goal is to use the subcommittee to
20 complement the work of the ARC by providing additional
21 insight into the potential challenges leading up to
22 2021 and the end of compelled Libor, identifying the

1 risks for financial markets and individual consumers,
2 and, above all else, providing solutions within the
3 derivatives space.

4 I have spoken publicly on this issue several
5 times since July in various forums and I intend to
6 continue to engage as wide an audience as possible to
7 ensure that market participants, both business and
8 legal, the global regulatory community, lawmakers, and
9 the general public are aware of the impending issues
10 and timelines and know that I am available as needed on
11 any matters that will serve to navigate to a smooth
12 transition.

13 With that said, I want to recognize and thank
14 Tom for his willingness to serve in the important
15 leadership role as subcommittee chairman.

16 And finally, I want to thank Chairman
17 Giancarlo for his continued support of this endeavor.
18 The Chairman and I are in lockstep and I am confident
19 the subcommittee's work will produce deliverables that
20 will be extremely valuable to the Commission and
21 ultimately global financial markets.

22 Turning to the primary issue of today's MRAC,

1 one of the core reforms outlined in the 2009 June
2 Pittsburgh Accord involved mandatory clearing of
3 standardized swaps and the Congress embraced this
4 reform in Title 7 of the Dodd-Frank Wall Street Reform
5 and Consumer Protection Act and the CFTC subsequently
6 finalized a series of rules defining the clearing
7 mandate.

8 Since March 2013, the clearing mandate has
9 led to a tectonic shift in the swaps marketplace.
10 According to data collected by the CFTC on U.S.
11 reporting entities, by 2017, about 85 percent of new
12 interest rate swaps and credit default swaps were being
13 cleared. The numbers speak for themselves and I
14 certainly believe and I know that I am not alone in
15 this, there will always be room for improvement and
16 that we can all strive to set policy and market
17 practices to further incentivize clearing where
18 appropriate.

19 As the financial crisis taught us, central
20 clearing works. While the unregulated OTC swaps market
21 played a role in the credit crisis, the exchange traded
22 futures books of major financial institutions proved

1 resilient in part because of central clearing.

2 Today's discussion will largely focus on
3 topics and issues raised by MRAC members related to
4 clearing and the roles and responsibilities of CCPs in
5 monitoring and in managing the variety of risks arising
6 from stresses, including but not limited to a clearing
7 member default.

8 The CFTC, along with its international
9 counterparts, is continually confronting the challenge
10 of building and maintaining the appropriate regulatory
11 framework for clearing in and among a population of
12 CCPs with unique risk profiles that will withstand
13 routine shocks and demonstrate resiliency in crises.

14 As the financial crisis also taught us, we
15 must cooperate and provide predictability while
16 remaining flexible in our approach to ensure the
17 response is appropriate when addressing an actual
18 crisis.

19 As well, we must constantly examine and
20 evaluate whether our rules effectively and
21 appropriately allocate duties and burdens in and among
22 CCPs, exchanges, intermediaries, and market

1 participants.

2 Today's panels aim to highlight how CCPs
3 currently approach their duty to engage in strong risk
4 management amidst our current regulatory landscape and
5 how global and domestic standard-setting bodies are
6 analyzing our current structures in support of making
7 any necessary changes.

8 Our first panel, facilitated by Robert
9 Steigerwald from the Federal Reserve Bank of Chicago,
10 will set the stage by providing an overview of current
11 risk management and governance issues with a focus on
12 the appropriate balancing of interests and incentives
13 between the clearinghouse and its members as well as a
14 consideration of clearing member and customer
15 viewpoints.

16 In our second panel, we will examine
17 management approaches to non-default losses generally
18 as well as in recovery and resolution and some of the
19 scenarios in which they may arise.

20 One such scenario could involve a cyber
21 security breach that creates non-default losses. Cyber
22 security as an operational risk issue is a concern that

1 has been voiced by many on this committee and as newer,
2 faster, and more pervasive technology permeates our
3 market infrastructure, the chance of a successful cyber
4 attack will likely increase.

5 If such an event occurred and caused losses
6 at the CCP, should those losses be met from available
7 CCP capital and other CCP assets or should they be
8 socialized amongst the clearing members or partially
9 covered by both?

10 The answers to these questions will likely
11 depend on the CCP itself, but by having the
12 conversation about how these losses can be dealt with,
13 we will be in a position to better understand how to
14 react when an operational investment or custodial risk
15 becomes a reality, particularly when non-default losses
16 occur as a part of this same event as default losses.

17 In our third panel, we will discuss some of
18 the most recent relevant reports from global standard-
19 setting bodies on the costs and incentives of clearing
20 and the resiliency, recovery, and resolution of CCPs.

21 Eight years after the first reforms were
22 implemented, the accumulated data can be used to

1 evaluate the effectiveness of the G20 clearing mandate
2 and related reform-based initiatives. Many of these
3 reforms have proven effective by moving risk from the
4 over-the-counter derivatives away from the unobserved
5 fringes of our financial markets and towards monitored
6 institutions that conduct central clearing and data
7 reporting.

8 This move has facilitated greater
9 transparency into market risks and provided increased
10 netting efficiencies. As the reports have shown,
11 however, these benefits have not come without costs and
12 there remain concerns regarding whether the regulatory
13 structure properly accounts for risk in terms of
14 capital, margin, and leverage.

15 Our last panel today will introduce a new
16 topic for MRAC and cover the oversight of third party
17 service providers and vendor risk management.

18 Exchanges, clearinghouses, intermediaries,
19 commission registrants, and their customers employ a
20 wide array of vendors that provide a myriad of
21 different services and each relationship carries its
22 own risk.

1 As all of these entities continue to increase
2 the number and complexity of relationships with vendors
3 through the outsourcing of businesses and regulatory
4 compliance functions, registrants must ensure that they
5 have appropriate management and control functions to
6 address the associated risks.

7 At the heart of those relationships is the
8 ability of market participants to know with whom they
9 are doing business, both directly and indirectly, and
10 what risks may arise from third party service
11 providers.

12 During this panel, we will hear from the
13 Office of the Comptroller of the Currency, whose
14 bulletin on the risk management of third party
15 relationships is considered among many to be the
16 eminent guidance on sound risk management across a
17 variety of relationships.

18 We will also hear from a principal provider
19 of services in our market and from our own supervisory
20 staff as we explore the current regulatory guidance and
21 tools at our disposal to evaluate, monitor, and manage
22 these risks, and consider whether the Commission's

1 current regulatory scheme works to mitigate risks posed
2 to market participants by third party service
3 providers.

4 It's my intention that this afternoon's panel
5 discussion on risks related to vendor relationships
6 will be the start of a longer conversation by this
7 committee and potentially a subcommittee with the
8 ultimate goal of providing the Commission with surgical
9 recommendations as needed to ensure market safety,
10 transparency, and resiliency.

11 As Chairman Giancarlo noted last week, market
12 reform is a continuous iterative process that requires
13 constant and consistent communication, coordination,
14 engagement, and evaluation.

15 As I have noted before, we do not observe the
16 current strength of the financial markets and
17 expansiveness of the regulatory landscape and conclude
18 that our job is done or worse that we can dial back our
19 efforts under the guise of excess.

20 We must all remain vigilant and not limit our
21 focus on the looming shadow of systemic risk to the
22 tools that we have. We must examine all of the

1 components in our systems and go beyond assessing and
2 assigning a metric of risk. We must strive to
3 understand and actively monitor and manage the risk of
4 each component at every system level and in every
5 connection.

6 As the risk footprints change or lead in
7 different directions, our goal must be to respond
8 through adaptation in our management and regulatory
9 responses.

10 In the international clearing space, we have
11 an interconnected highly-concentrated system comprised
12 of other interconnected somewhat less-concentrated
13 systems. This is all governed by regulations held
14 together by consensus-based principles aimed at
15 preserving and strengthening financial stability.

16 Within that structure, the points of
17 potential default and larger catastrophic failure are
18 too numerous and many too remote to account for.
19 Nevertheless, we must persist in our analysis and
20 participate in coordinated efforts to better
21 understand, better inform, and better address risks in
22 all its forms.

1 This committee is among those efforts and its
2 ongoing operation and input contributes to our ongoing
3 processes.

4 I'm very excited about our agenda for today
5 and want to again recognize the tremendous amount of
6 work that has gone into planning this meeting and thank
7 everyone for being here.

8 MS. LEWIS: Thank you, Commissioner Behnam.

9 Before we begin, I would like to do a roll
10 call of the members that are on the phone so that we
11 have your presence on the record. After I say your
12 name, please indicate your presence. Operator, please
13 give the individuals that have been cited as having
14 speaking rights the ability to indicate their presence.

15 (Roll Call.)

16 MS. LEWIS: Thank you.

17 Just a few logistical reminders before moving
18 forward with the agenda. Committee members and
19 panelists, please make sure your microphone is on when
20 you speak. The meeting is being simultaneously webcast
21 and it is important that your microphone is on so that
22 the webcast audience can hear you.

1 Also, please lean into the microphone when
2 you speak and keep your phones away from the console
3 because we get feedback.

4 Members, if you'd like to be recognized
5 during the discussion, please change the position of
6 your place card so that it sits vertically on the table
7 or raise your hand and either I or the panel's
8 facilitator will recognize you and give you the floor.

9 Members on the phone, we will give you an
10 opportunity to ask questions or make comments either at
11 the beginning or end of our discussions.

12 As Commissioner Behnam stated, our first
13 order of business today will be a report from the
14 MRAC's Interest Rate Benchmark Reforms Subcommittee.

15 As you may recall, as Commissioner Behnam
16 said at our July meeting, the MRAC voted to recommend
17 to the Commission to establish a Libor subcommittee.
18 The subcommittee has been established and held its
19 first meeting recently.

20 Tom Wipf, we ask that you bring the report of
21 the subcommittee.

22

1 Report from Interest Rate Benchmark Reform Subcommittee

2 MR. WIPF: Thank you, and good morning,

3 everyone.

4 I appreciate the opportunity to present again

5 in front of the Market Risk Advisory Committee on

6 behalf of our newly-formed Subcommittee on Interest

7 Rate Benchmark Reform.

8 For those I've met, my name is Tom Wipf, Vice

9 Chairman of Institutional Securities at Morgan Stanley.

10 I additionally represent our firm on the Fed's

11 Alternative Reference Rate Committee and the Board of

12 ISDA.

13 And before we begin, I have to say that my

14 views are not representative of the ARC or Morgan

15 Stanley and they are my own.

16 I want to also take a moment to thank

17 Commissioner Behnam and Alicia Lewis, this committee,

18 the MRAC, the rest of the CFTC for forming this

19 subcommittee, additionally thank you to Commissioner

20 Berkovitz, Commissioner Stump, and Chair Giancarlo for

21 the opportunity to present the results of our

22 organizational meeting to you today.

1 The transition to alternative reference rate
2 is a major challenge ahead of us and for us to achieve
3 success, it is paramount that we have close
4 coordination between the public and private sector.

5 I also want to thank before we get rolling
6 the other members of the subcommittee. Their names
7 have been announced today. They're in your packets.
8 In the interest of time, I think if people just want to
9 take a look at them, but what I will tell you is, as
10 you read the names, you will see that this is a very
11 well-qualified group of participants from all parts of
12 the market and I can certainly report that from our
13 first meeting, there is no hesitation for people to
14 want to get on with this work.

15 So our organizational meeting was quite
16 active and I think that we're making progress right out
17 of the chute.

18 I'd like to begin the discussion by just
19 recalling a bit from our July MRAC meeting and that
20 resulted in the creation of this subcommittee. So back
21 on July 12th, we moderated a panel in front of MRAC
22 that covered several different important areas

1 regarding the transition to alternative benchmark rates
2 in the U.S.

3 During that panel, we discussed an overview
4 of Libor reform, latest developments with Libor, SOFR,
5 SOFR derivatives, and the effect of Libor reform on the
6 derivatives industry.

7 We heard from industry experts who have been
8 instrumental in raising awareness and moving the ball
9 forward on Libor reform as it relates to their
10 institutions, their clients, and their counterparties.

11 At the conclusion of that committee meeting,
12 the MRAC voted to form a subcommittee on interest rate
13 benchmark reform and to provide reports and
14 recommendations to the MRAC on the effect of current
15 Libor reform initiatives on the derivatives markets.

16 Since that MRAC meeting, there have been
17 several material updates to Libor reform around the
18 globe. In the U.S., market participants are working to
19 create and implement fallback language that can be used
20 in newly-issued cash products. We're also working
21 actively to use the new rates available through
22 derivative contracts in the form of SOFR futures and

1 SOFR swaps.

2 In the U.K., large banks and insurance
3 companies are working to complete their Dear CEO letter
4 ahead of this month's deadline. In Europe, a place
5 where benchmark rate has been selected and market
6 participants are forming their transition plan ahead of
7 the deadline imposed by the EU benchmark regulation.

8 Market participants globally are focused on
9 the preliminary results of ISDA's market consultation
10 on fallback calculation methodology for derivative
11 contracts. Although USD Libor was not in scope for
12 this particular consultation, the results of the
13 consultation are still viewed as significant for U.S.
14 market participants as they may provide an indication
15 how the eventual ISDA protocol for USD Libor fallback
16 methodology is calculated.

17 With the formalization of subcommittee's
18 membership this morning, we are now hard at work to
19 identify areas of the Libor transition in which we can
20 provide input and recommendations to the MRAC and to
21 the Commission.

22 In charting our intended contribution to the

1 MRAC and broader CFTC, the subcommittee has defined our
2 areas of focus and the boundaries of our work. The
3 ultimate goal of our Subcommittee on Interest Rate
4 Benchmark Reform is to provide input and
5 recommendations to the MRAC as it relates to potential
6 policy changes that may impact the course of Libor
7 reform.

8 Our key principles that we -- our first
9 principles that we put forward is (1) we aim to remove
10 hurdles to the transition to SOFR, (2) we aim to
11 suggest incentives for market participants to
12 transition to SOFR, and we aim to accomplish all that
13 while avoiding any inadvertent creation of a safe
14 harbor and policy changes that would create any
15 activity that was away from the transition to new
16 rates.

17 The deliverables that our subcommittee
18 presents to MRAC will be detailed, specific, and
19 actionable in nature. Further, our intention is to
20 submit these proposals and recommendations to the MRAC
21 within a reasonable amount of time, based on certainly
22 the group that's been assembled here. The list of

1 things we need to do is fairly straightforward. We
2 want to put work streams behind that and get things
3 moving fairly quickly.

4 In forming our recommendations, we are
5 mindful that our duty is to the broader market and not
6 to individual institutions. Apart from providing
7 proposals to the MRAC, the subcommittee also recognizes
8 that it has a responsibility to continue to raise
9 awareness of the reference rate transition among market
10 participants.

11 As we move through this, we've really
12 described this as we are entering sort of the second
13 act of a three-act play. For the last four-five years,
14 there's been a lot of work on understanding the issues,
15 on educating market participants, on spreading
16 basically the word around of what it means to
17 transition, what are some of the vulnerabilities of the
18 current Libor, and then moving things forward.

19 As we sort of enter this phase now, we are
20 seeing things that are actionable, things that can take
21 place. We see it very close to having a fallback for
22 derivatives. We have over 20 billion in cash market

1 issuance, floating rate notes using SOFR. We're seeing
2 activity in both swaps and futures.

3 So there are things that are happening now
4 and I think as we move to sort of Phase 3, that will be
5 the final implementation that we see as we approach
6 2021.

7 We also believe that meaningful progress
8 between now and then will make for, you know, a much
9 smoother transition and that will be a focus of this
10 group, as well.

11 Given the collective expertise and the reach
12 of the members of the subcommittee, we really want to
13 strive to be a force for good as the broader market
14 prepares for Libor reform.

15 In selecting the members of the subcommittee,
16 it is clear that the intentions were to capture a large
17 cross-section of the market in order to maximize the
18 committee's ability to create awareness and to track
19 our progress in a meaningful way and to ensure that all
20 participants in the market are heard from in this
21 process.

22 The subcommittee includes members from asset

1 managers clearinghouses and users, exchanges,
2 intermediaries, market-makers, service providers, and
3 trade associations.

4 In carrying out our mandate, we are also
5 mindful of the finite scope and boundaries of the work.
6 Specifically, the subcommittee is limiting its focus to
7 policies and recommendations involving the U.S.
8 derivatives market.

9 We'll work within these boundaries in order
10 to provide actionable and policy-driven input to the
11 MRAC. This is consistent with the mission of the CFTC
12 and the spirit in which the subcommittee was created.

13 Next steps. In light of our focused approach
14 and a desire to provide input to the MRAC within a
15 reasonable time frame, the subcommittee at our
16 organizational meeting has already charted out a plan
17 of attack to accomplish the goals.

18 Last week, we had an introductory phone call
19 to discuss the mandate, to set our first principles,
20 and the remit of the committee. As a starting point,
21 we're going to leverage the work that was done by the
22 ARC in its letter to the U.S. regulators, dated July

1 12th, 2018.

2 In this letter, the ARC and member firms
3 requested specific interagency guidance regarding the
4 treatment under regulations pursuant to Title 7 of
5 Dodd-Frank Wall Street Reform and Consumer Protection
6 Act of existing derivatives contracts or amended to
7 include new fallbacks or otherwise reference
8 alternative risk-free reference benchmarks and new
9 derivative contracts that reference RFRs.

10 The proposals we ultimately provide will be
11 additive to this letter, not repetitive. It is of top
12 priority that the policy-based recommendations that we
13 make to MRAC will not inadvertently create loopholes or
14 safe harbors that go against MRAC's primary goals for
15 the subcommittee.

16 By the end of this month, the subcommittee
17 will gather and circulate internally thoughts on
18 regulation of the U.S. derivatives markets that could
19 potentially be refined in order to encourage the
20 transition to SOFR. As a result of our initial
21 subcommittee call last week, we are already hard at
22 work in this regard.

1 We will meet in January and on a monthly
2 basis thereafter to further discuss and collaborate in
3 an effort to deliver meaningful and actionable results
4 to the MRAC.

5 We aim to provide MRAC with substantial
6 update on our progress at the meeting, following each
7 meeting, and we plan to memorialize our work very
8 clearly to ensure that there is a body of work behind
9 these recommendations that will articulate clearly the
10 design, the reasoning, and the approach that the
11 committee has taken prior to making any recommendations
12 back to this committee.

13 Our objective is to be helpful to the MRAC
14 and the broader CFTC as you further implement strategy
15 to facilitate and encourage the transition to SOFR and
16 the U.S. derivatives market.

17 We applaud the MRAC and CFTC for prioritizing
18 this important issue and being front-footed with
19 regards to executing the reference rate transition
20 successfully.

21 The creation of this subcommittee as well as
22 recent comments from Chairman Giancarlo are evidence

1 that the transition to alternative reference rates has
2 been appropriately prioritized here.

3 Once again, I would like to thank
4 Commissioner Behnam, Alicia Lewis, and MRAC for this
5 opportunity to present. The subcommittee is intently
6 focused on creating actionable recommendations to
7 further the market's progress as it relates to the
8 transition to alternative reference rates.

9 We strive to be additive to other sources of
10 market progress, remain focused on the scope and remain
11 well connected to the work that's happening outside
12 this group and ensure that we are synced up very well.

13 We welcome feedback from the MRAC on the
14 principles that we set forth, the three first
15 principles that we described, and we look for feedback
16 on anything we've discussed here today.

17 With that, that concludes my prepared
18 remarks, and I will pass it back to Alicia to solicit
19 any questions from the room, comments, feedback, or
20 criticism.

21 MS. LEWIS: At this time, I would like to
22 open the floor to questions or comments from the MRAC

1 membership.

2 Thank you, Tom.

3 CHAIRMAN GIANCARLO: Tom, --

4 MS. LEWIS: Chairman Giancarlo.

5 CHAIRMAN GIANCARLO: -- thank you. Thank you
6 very much for that. It gives me a great sense of
7 confidence and optimism that the subcommittee will
8 bring to the attention of the MRAC and through that
9 through the Commission if there's anything that we're
10 not doing that we should be doing, which is very
11 helpful.

12 Is there anything that outside of the CFTC
13 and our fellow U.S. regulators can be doing to help --
14 and I think you made the point about really getting the
15 word out. Is there anything more that can be done to
16 get the word out really into the heartland?

17 MR. WIPF: Yes, I think I can certainly say,
18 and for folks around this table and folks who will be
19 on the subcommittee, it's really clear that when we
20 have these discussions, I think, at our individual
21 firms and we speak to, you know, large groups of
22 clients or individual groups of clients, what we're

1 finding is that there's a wide variety of where people
2 are in this evolution.

3 So clearly, you know, when we speak to large
4 institutions, there are programs in place, people are
5 doing the things that they need to do to get this
6 transition organized and so forth, but then we find,
7 you know, infrequent users of derivatives markets or
8 infrequent issuers who are much less focused on this.

9 So, you know, I think that, you know, this
10 really is going to involve pretty much everyone in the
11 market grabbing an oar anywhere they can.

12 We are finding that just getting out and
13 getting the information out there, but clearly the CFTC
14 is extremely well positioned in this area to educate
15 and to push this forward and I think that, you know,
16 from our view on this, having been with the ARC since
17 its inception, the first couple of years has really
18 been just identifying, getting people to take a hard
19 look at Libor, look at the vulnerabilities, and think
20 about how to transition to the new rates.

21 With the rates available, with some activity
22 in the cash markets, with activity in derivatives

1 markets, I think it is a continued education but
2 certainly to get well beyond the large institutions who
3 clearly are focused on this, to get deeper into the
4 markets.

5 I think the CFTC is extremely well positioned
6 on this and we would look for any support on that to
7 just continue to just educate, push forward, and
8 really, I think as the calendar turns to 2019, 2021
9 doesn't seem that far away anymore.

10 So the more we can do to move things forward,
11 the more certainly your supportive comments and the
12 supportive comments that we've heard from, you know,
13 the public sector has been extremely helpful and the
14 more of that to raise awareness the better and anything
15 else on the table to kind of push this forward.

16 We do find in every one of our broader client
17 meetings that the spectrum ranges from we're just
18 hearing of this to we're absolutely rolling along with
19 a full program. So anything we can do to fill those
20 gaps, anything you can do to fill those gaps would be
21 greatly appreciated I'm sure by this subcommittee and
22 its members.

1 CHAIRMAN GIANCARLO: Thanks, Tom. As I've
2 shared with you and with Commissioner Behnam and
3 others, I think the word is out in the London, New
4 York, Washington corridor. My worry is the word is not
5 out in Kansas City and Atlanta and in Dallas and
6 elsewhere.

7 I know the ARC has recently been in
8 Continental Europe speaking to lending institutions
9 there but we need to get ARC in front of lenders across
10 this wonderful country to speak to small lenders,
11 homebuilders, others that extend credit in the markets
12 that rely on Libor that the days of Libor are numbered
13 and that SOFR is on its way and we need to get that
14 word out.

15 We need to find a way and a means to get ARC
16 activated across the country.

17 MR. WIPF: I couldn't agree more, sir. I
18 think what we have is an opportunity and I think, as
19 Sandy O'Connor, Chair of the ARC, has put it, we're not
20 running from Libor, we're sort of running to SOFR, and
21 I think getting people around that idea that there is
22 an existing set of risks that we all share, there's

1 this collective action that needs to take place to
2 actually move this forward. This is a reference rate
3 that was created by the market and has to be repaired
4 by the market.

5 So as we take this forward, any of those
6 opportunities to take this into the heartland will be
7 greatly appreciated.

8 I would also suggest that, you know, like
9 members of the ARC, you know, members of our
10 subcommittee will be asked at their own individual
11 firms to continue to, you know, sort of be preaching
12 this, as well, and making sure that this information is
13 working its way through their systems, through their
14 clients, and so forth.

15 So the more each of these committees can
16 instill in their membership, you know, a general
17 requirement and spirit of this to get out there and
18 sort of continue to spread the word among their clients
19 and counterparties, the better we can do, and certainly
20 as I said before, I think the CFTC's extremely well
21 positioned to provide a lot of support there.

22 CHAIRMAN GIANCARLO: Commissioner Behnam, you

1 have great experience in taking the show on the road,
2 conducting an advisory committee in Kansas City next
3 year. Maybe we can have MRAC committee meetings
4 elsewhere in the country to help spread the word on
5 Libor.

6 COMMISSIONER BEHNAM: Thanks, Chairman, and
7 thanks, Tom, and I couldn't agree with you more.

8 Like I said in my statement, we are in
9 lockstep and we will continue to take advice from you,
10 Tom, for certain, but also be happy to interchange and
11 I think we can all benefit from it to make sure that
12 folks across the country learn about this.

13 MS. LEWIS: Thank you.

14 I'd like to recognize Stephen Berger,
15 Citadel.

16 Mr. Berger: First off, I'd like to thank the
17 Commission and the MRAC for focusing on this important
18 topic and thank you, Tom, for leading the efforts here.

19 Just one kind of comment and observation from
20 our perspective. We think that as liquidity starts to
21 build in swaps referencing SOFR and other risk-free
22 rates, it's important that we build it within the open,

1 competitive, and transparent clearing and trading
2 framework that we've all worked so hard over the last
3 five plus years to build for swaps referencing Libor.

4 Otherwise, we fear that this very-much-needed
5 transition to sounder risk-free reference rates and
6 derivatives referencing those rates could be
7 accompanied by at least a pause or some steps backwards
8 in terms of markets building integrity.

9 As things stand now, the Commission's
10 reporting rules in Part 43 and 45 by default already
11 apply to the new activity that's occurring in swaps
12 referencing SOFR and I think that's been quite valuable
13 in the nascent stages as we've been able to observe the
14 activity that is starting to occur in the swaps market
15 and, you know, we also have data obviously on what's
16 happening in the futures market and data's being
17 compiled on what cash instruments is occurring that's
18 references SOFR.

19 So being able to look at all three of those
20 products in a transparent fashion, I think it's very
21 helpful to market participants as they begin to think
22 about transitioning their own activity into products

1 that reference SOFR.

2 By contrast, as it stands now, the
3 Commission's, and this is obviously probably
4 appropriate in the nascent stage, but as it stands now,
5 the Commission's clearing and trading requirements do
6 not by default apply to swaps referencing SOFR.

7 With respect to clearing, that would require
8 clearing determination to be made in the form of a rule
9 proposal and then on the heels of that, it potentially
10 would take a step at least under the status quo to make
11 a determination.

12 So I'm not saying either of those things need
13 to happen today by any means and from the data we've
14 seen, it appears that the vast majority of activity in
15 SOFR swaps is already happening on a voluntary basis in
16 a cleared environment, but I think at least our hope
17 and aspiration for the subcommittee is that we would
18 have a thoughtful but forward-leaning set of
19 recommendations that will solve the very collective
20 action problem you mentioned so that as we build this
21 new liquidity pool, we do it again in a way that
22 benefits from the solid framework we've already

1 established for Libor swaps.

2 MR. WIPF: Yeah. I think we discussed that
3 and we laid that against sort of the first principles
4 we've laid out. I think that that's certainly a topic
5 that the committee should be looking at.

6 I think if we think about the idea that, you
7 know, to remove obstacles, to create incentives, and to
8 avoid inadvertent safe harbor outcomes, I think that
9 we'll take that onboard and we'll have those
10 discussions.

11 MS. LEWIS: The Chair recognizes Jim
12 Shanahan, CoBank.

13 MR. SHANAHAN: I'd like to thank the
14 Commission for putting the emphasis on the benchmark
15 reform. It's something that the farm credit banks are
16 significant users of Libor in our lending and one of
17 the things is that we have really done a lot of
18 outreach to the financial institutions we finance
19 because we want to encourage the market to start
20 thinking about the resources and systems that are going
21 to be touched by this aspect and I do think it's a
22 great aspect that you guys are going to come out to

1 Kansas City, hold another meeting.

2 It was a very productive meeting last year
3 and outreach. We're doing a lot of education with our
4 customers right now just to convince them this isn't
5 another game to harvest value out of them and let them
6 know that this is an enhancement and not, you know, a
7 punitive step and there's just a lot of education, and
8 I encourage you guys to speak on this every chance you
9 get.

10 Thank you.

11 MS. LEWIS: Thank you, Jim.

12 Anyone else?

13 (No response.)

14 MS. LEWIS: Are there any members on the
15 phone that have questions or comments?

16 (No response.)

17 MS. LEWIS: Well, if not, thank you, Tom, and
18 members of the subcommittee. We look forward to
19 hearing more about the subcommittee's efforts at the
20 next meeting and for all of you in the audience, the
21 list of subcommittee members is also on the agenda
22 table and the press release was issued earlier this

1 morning.

2 Okay. So now we'll start our discussions on
3 Clearinghouse and Vendor Risk Management.

4 MR. WIPF: Thank you very much.

5 MS. LEWIS: Thank you, Tom.

6 Our first panel discussion will be on
7 Clearinghouse Risk Management and Governance today. I
8 ask that the facilitator and speakers come forward and
9 take their seats at the panelist table. You do not
10 need your tank cards.

11 The facilitator, Bob Steigerwald, you come
12 sit by me.

13 As Commissioner Behnam stated earlier, Robert
14 Steigerwald will facilitate and help shape the
15 discussion during the panel.

16 Robert Steigerwald is a Senior Policy Advisor
17 for Financial Markets in the Federal Reserve Bank of
18 Chicago's Economic Research Department, where his work
19 focuses on public policy issues relating to financial
20 market infrastructure.

21 He also formerly represented the Federal
22 Reserve Bank of Chicago and the OTC Derivatives

1 Regulators Forum, an international forum for
2 information-sharing and regulatory cooperation among
3 central banks, prudential supervisors, and market
4 regulators with respect to clearing and settlement
5 arrangements and trade data repositories for OTC
6 derivatives.

7 Mr. Steigerwald is a graduate of the State
8 University of New York at Stony Brook with a BA and the
9 University of San Francisco School of Law with a JD,
10 and he's also a member of the MRAC. So we are very
11 happy that he has volunteered to facilitate today's
12 panel.

13 I will turn it over to Bob.

14 Panel 1: Clearinghouse Risk Management and Governance
15 Today

16 MR. STEIGERWALD: Thank you very much,
17 Alicia. Thank you, Commissioner Behnam, for giving me
18 the privilege of leading this very important
19 conversation this morning.

20 Before we get to the business of this panel,
21 just a reminder, Alicia wants to make sure that we
22 follow the rules of good participation in the

1 conversation using our microphones, turn them on,
2 please, when you are speaking and turn them off when
3 you have finished speaking. Also, as before and
4 throughout this meeting, you may enter the conversation
5 by raising your name tent to a vertical position and
6 you will be recognized by the Chair.

7 And I hope that I will use by own good
8 example of speaking loudly and clearly so that the
9 folks on the other end of the line can hear us as an
10 example to all of you.

11 In the event that I should say anything novel
12 or noteworthy, much less controversial today, it is
13 incumbent upon me to issue the standard fed disclaimer
14 that my remarks are solely my own and not those of the
15 Federal Reserve Bank of Chicago or the Board of
16 Governors of the Federal Reserve System. It's not my
17 intention to do any of those things but sometimes
18 things slip out.

19 So just a few remarks to frame the issue to
20 be discussed in this panel.

21 We are, of course, tasked with discussing CCP
22 governance as well as risk management policies and

1 practices and this is quite a full set of issues that
2 are both distinct at times and that blur into each
3 other at other times.

4 Governance, I think, can be thought of in
5 both a broad and a narrow sense. Broadly speaking,
6 governance can include the role of public regulators
7 overseeing CCPs as well as their members. It can also
8 include the internal governance arrangements, rule-
9 setting, supervision, market surveillance that takes
10 place within a CCP, and, of course, in a more narrow
11 traditional sense, there are the very thorny issues of
12 corporate governance that are especially difficult in
13 an association that is designed to represent many
14 different, sometimes conflicting interests, all of
15 which must be integrated somehow into a cooperative
16 effort to manage risk to the benefit of the users of
17 the CCP as well as the public as a whole.

18 In that respect, governance bleeds very
19 easily into issues of transparency, flexibility,
20 decision-making, and so forth.

21 Some of the issues that are properly
22 construed as governance issues, many of them in fact,

1 will involve strictly risk decisions. Some of them
2 will not. So we will sometimes see issues of
3 structure, the nature of the decision-making process at
4 a CCP rise to the fore. At other times, we will, I
5 think, see technical issues, sometimes contested,
6 relating to risk management practice and policy come to
7 the fore.

8 Underlying all of this, I think, is a
9 fundamental problem of financial regulation, which is
10 the thorny problem of wrestling with fundamental
11 tradeoffs.

12 I think that will be well illustrated by the
13 range of topics that have been identified by members of
14 the committee for discussion in this panel and we will
15 find ourselves, I think, from time to time faced with
16 choices that can't easily be reduced to a single
17 solution.

18 Lastly, one of the objectives of this panel
19 discussion is to identify best practices that can be
20 adopted more broadly by the industry.

21 I emphasize the plurality of the term "best
22 practices." There may be an inadvertent or

1 subconscious inclination to regard best practice as
2 implying that only a single path is possible. As
3 Commissioner Behnam noted in his remarks this morning,
4 flexibility can be an important contributing factor to
5 the coordination and cooperation that is necessary for
6 these markets to operate properly and we should remind
7 ourselves, I think, that flexibility and diversity
8 itself can contribute to financial stability.

9 That concludes the general framing remarks
10 that I have and so I hope that they will serve as a
11 foundation for the conversation to follow.

12 Let me turn now to the first of our speakers.
13 Marnie Rosenberg is Managing Director and Global Head
14 of Clearinghouse Risk & Strategy at JP Morgan Chase &
15 Company. Her biographical information is available in
16 the packets that are being circulated. I thought I
17 would not take the time of the committee to go into
18 that detail.

19 Marnie, would you please begin with your
20 opening statement?

21 MS. ROSENBERG: Thank you, Robert.

22 Good morning. My name is Marnie Rosenberg,

1 and I'm the Global Head of Clearinghouse Risk &
2 Strategy within JP Morgan's Independent Risk Management
3 function.

4 Thank you, Commissioner Behnam and Alicia
5 Lewis for putting the topic of clearinghouse risk and
6 governance on today's MRAC agenda and for providing me
7 with the opportunity to present our views.

8 We have raised issues related to CCP risk,
9 recovery, and resolution through two JP Morgan white
10 papers and a recent clearing member default has once
11 again highlighted the importance of getting
12 clearinghouse risk management and governance right.

13 Derivative market reforms, including swaps
14 clearing mandate and non-cleared swaps margin rules,
15 have increased the volume of cleared derivative
16 transactions. While this has reduced central
17 counterparty clearing risk and enhanced transparency in
18 the derivative markets, it has also led to
19 concentration of risk in CCP use and increased inter-
20 connectiveness within the system.

21 Global standard-setting bodies and
22 regulators, including the CFTC, have recognized the

1 need to assess the full implications of these changes
2 and determine whether enhancements are needed to ensure
3 that CCPs' risk management and governance frameworks
4 remain commensurate with the systemic role that CCPs
5 have now assumed.

6 While good progress has been made,
7 opportunities remain to further improve CCP governance
8 and margin and stress testing frameworks as well as
9 increase CCP capital contributions through enhanced
10 regulatory standards and oversight.

11 CCPs make key decisions with respect to how
12 they manage risk, setting membership and eligible
13 collateral criteria, margin levels, and overall
14 financial safeguards as well as determining specific
15 products that they will offer for clearing, and most of
16 the global CCPs are subsidiaries of publicly-owned
17 holding companies that face competitive pressure to
18 maximize shareholder returns.

19 At the same time, clearing members bear the
20 consequences, the capital consequences of losses
21 through the collective default fund contributions they
22 provide to the CCP for loss mutualization.

1 This model creates an imbalance by separating
2 the rewards of ownership from its risks, creating a
3 misalignment of risk management incentives.

4 Risk governance rules should ensure that
5 those that bear potential losses have a meaningful
6 voice within regard to how risk is managed. While
7 employees of some clearing members participate on CCP
8 risk committees, this does not equate to member input
9 into decision-making as representatives have varied
10 roles.

11 As such, there is a need to enhance CCP risk
12 management governance processes such that they
13 incorporate independent expert views from
14 representatives of end users and clearing members who
15 serve as members of a CCP's risk committee.

16 Provide all clearing members with an
17 opportunity to provide their input at the design stage
18 on key risk decisions being considered by a CCP and
19 require appropriate documentation of a CCP's rationale
20 and justification in cases where feedback from a
21 clearing member or risk committee is not incorporated.

22 While the governance requirements I just

1 described exist under the EU's European market
2 infrastructure regulation or EMIR, they do not form
3 part currently of the CFTC's rules. Incorporating
4 enhancements in Part 39 and Part 40 of the CFTC's
5 regulations would serve to enhance CCP resilience by
6 ensuring that participant risk management expertise is
7 duly considered and incorporated where appropriate.

8 Enhancements to CCP governance, risk
9 governance frameworks should be coupled with the
10 requirement for CCPs to contribute meaningful amounts
11 of own funds capital or skin in the game to ensure
12 alignment of incentives.

13 While many CCPs contribute some capital to
14 their default waterfalls, amounts do not scale with
15 risk and represent a small percentage of the member
16 default fund, therefore not being sufficient currently
17 to ensure alignment of incentives.

18 As an example, in the U.S., one large listed
19 CCP does not have any skin in the game while another
20 has capital equal to three percent of its member
21 default fund, neither of which is sufficient.

22 Regulators should ensure that CCP capital is

1 sufficient to both align incentives for management of
2 default losses and cover non-default losses which
3 should not be borne by members and their clients.

4 We support the CFTC's commitment to fair and
5 open access and believe that implicit with providing
6 access to well-capitalized members is the need -- less-
7 capitalized members is the need for CCPs to actively
8 monitor and manage exposures brought in by such
9 members.

10 CCPs must ensure that each member can meet
11 increased margin calls and must be able to take action
12 to reduce risk towards members with weakening credit.

13 Margin frameworks review is the first line of
14 defense in case of a member default. CCPs must ensure
15 that their margin frameworks are robust, are stable,
16 account for position concentration, and are adequate
17 through the time it takes to close out a defaulter's
18 positions.

19 We have observed significant margin breaches
20 during periods of high volatility this year. CME, ICE,
21 OCC, Japan Securities Clearing Corp., NASDAQ, and EURX
22 all experienced margin breaches in excess of a hundred

1 percent, based on a one day market move, and these were
2 followed by the CCPs subsequently increasing margin
3 levels.

4 Pro-cyclical calls for margin could trigger
5 defaults by weaker members. More work, we believe, can
6 be done by CCPs to demonstrate that the margin period
7 of risk assumed as well as the margin collected
8 adequately reflects the liquidity profile of the
9 underlying product, regardless of how the product is
10 traded or classified, whether it be OTC or listed.

11 Lastly, participants need sufficient
12 transparency over CCP margin and stress testing
13 methodologies to enable them to conduct in-depth
14 analysis and be able to fully understand their
15 membership risks.

16 Transparency still remains a challenge,
17 despite steps taken by the industry and regulators to
18 enhance disclosures.

19 Thank you, and I look forward to our
20 discussion.

21 MR. STEIGERWALD: Thank you, Marnie.

22 I'll turn now to our next panelist, Alicia

1 Crighton. Alicia is Chief Operating Officer, Prime
2 Services, US Clearing at Goldman Sachs, and she is
3 representing the Futures Industry Association in her
4 remarks here today.

5 Thank you.

6 MS. CRIGHTON: Thanks, Bob.

7 Good morning. I'm Alicia Crighton, and I'm
8 the COO of the Prime Services Clearing Business at
9 Goldman Sachs, and as Bob said, I'm also the FIA
10 representative to MRAC.

11 It is as the FIA rep to MRAC that I'll be
12 speaking to you today.

13 Thanks to Commissioner Behnam and to Alicia
14 Lewis for the opportunity to speak with you this
15 morning.

16 The increase in volumes cleared by CCPs,
17 particularly stemming from the G20 mandate, can lead to
18 enhanced financial stability but also requires that
19 CCPs engage in strong risk management.

20 FIA and its clearing members are strong
21 proponents of a healthy and safe clearing system that
22 mitigates systemic risk for the cleared derivatives

1 business.

2 While FIA members are focused on a number of
3 areas related to CCP risk management, I'll categorize
4 my remarks today into three categories: governance,
5 adequacy and resources of CCP member firms, and CCP
6 skin in the game.

7 On governance, I'll highlight four areas
8 important to FIA members. First, regulatory
9 supervision of CCPs should include regular and granular
10 assessments. These assessments should include strong
11 testing across a range of scenarios and at different
12 stages of default management to ensure adequacy of
13 resources when they're needed.

14 Stress testing by regulators is an essential
15 aspect of supervising CCPs and thus ensuring financial
16 stability. While regulatory supervision is critical,
17 it is important to note that all parties involved,
18 clearing members, CCPs, and regulators, have a crucial
19 role to play in the risk management ecosystem.

20 Second, CCPs should establish a framework to
21 give clearing members a more robust role on risk
22 committees. Risk committees need to have a greater say

1 with regard to products cleared, the robustness of
2 their margin methodologies, and which default fund is
3 appropriate to cover products.

4 Current involvement of individual members in
5 risk committees is inadequate for ensuring reliable and
6 sufficiently-robust margin methodologies and CCPs
7 should ensure a high level of transparency of their
8 margin methodology with members and establish a
9 framework whereby input from members on the
10 methodologies can and should be considered.

11 Third, CCP default management processes
12 should be transparent and CCPs should permit clearing
13 member participation. The design of default management
14 processes, including the use of options, is critical in
15 minimizing losses.

16 As FIA has argued, transparency is critical
17 to members and this criticality continues post-default.
18 Issues, such as the number of participants and how the
19 defaulter's portfolio is arranged for and whether an
20 auction is necessary in light of the nature of the
21 product are of critical interest to non-defaulting
22 members since they are required to absorb losses

1 resulting from the defaulter's portfolio.

2 Fourth, CCPs should enhance governance around
3 the development of margin models to bring the
4 quantitative and risk management experience and
5 resources of clearing members to bear.

6 CCPs ensuring the defaulter's initial margin
7 is a primary source of funds to meet the CCP's losses
8 upon default and so ensuring margin model adequacy and
9 performance is critical.

10 Margins should cover market risk over the
11 period that it would take to detect a default, commence
12 default management proceedings, and liquidate a
13 defaulting participant's positions.

14 Concentration and liquidity risk must be
15 accounted for by CCPs and this is best dealt with as
16 part of margin. In addition, cross-product netting of
17 margin should be considered from the perspective of
18 risk management and the robustness of the underlying
19 rationale and not margin efficiencies.

20 Margin efficiencies which yield lower
21 requirements should not be a source of competition
22 among CCPs and issuing intraday margin calls to members

1 should not be seen as an alternative to adequate margin
2 levels and should be primarily used to ensure the CCP
3 does not extend more credit to members than
4 appropriate.

5 There is more work to be done in order to
6 remove the uncapped liability to clearing members on
7 some international CCPs as this risk is unsustainable
8 to the clearing member community.

9 With regard to adequacy and resources of CCP
10 members, first, FIA believes CCP membership criteria
11 should be fully transparent, detailed, and specific.
12 Second, CCPs should not rely on only external credit
13 ratings for monitoring membership. They should have an
14 internally-developed credit framework, whether it is
15 outsourced or applied by the CCPs' risk function, for
16 reviewing creditworthiness of participants.

17 Third, CCPs who wish to include self-clearing
18 members should develop specific provisions in their
19 rulebook, risk framework and governance to account for
20 the nature of these members. A self-clearing member
21 does not have the buffer of another sophisticated
22 financial intermediary carrying out risk monitoring and

1 thus requires a higher level of scrutiny by the CCP.

2 This level of scrutiny could include exposure caps for
3 more thinly-capitalized firms.

4 Any market participant that is not capable of
5 having in place meaningful trading and risk controls
6 and credible separated business functions, such as
7 risk, compliance, trading, and operations, which are
8 independent of one another, should not be permitted to
9 be a clearing member of a CCP.

10 Lastly, FIA believes CCP skin in the game
11 should align the interests of CCPs with those of its
12 members. Specifically, it should be calculated by
13 reference to the level of risk being managed by the
14 CCP. To act as an incentive, a significant portion of
15 it should be used ahead of any non-defaulting member
16 resources in the default waterfall.

17 It should be correctly sized for the
18 potential default of self-clearing members, taking into
19 account that they may not be required to provide
20 default fund contributions under the same calculation
21 as other clearing members and may not have the
22 financial resources available in stress scenarios that

1 larger financial institutions do, and it should be
2 dynamic and recalibrated periodically to account for
3 the changing level of the default.

4 Thank you again for this opportunity. I look
5 forward to taking any questions that you have.

6 MR. STEIGERWALD: Thank you, Alicia.

7 Next, we have Lee Betsill. Lee is Managing
8 Director and Chief Risk Officer at CME Group.

9 Lee.

10 MR. BETSILL: Thank you, Robert.

11 I'll just clarify. I'm the Chief Risk
12 Officer of the CME Clearinghouse.

13 I'm Lee Betsill and like my other panelists
14 and other members of the committee, I thank Alicia and
15 Commissioner Behnam for organizing this event and for
16 the opportunity to be able to speak about CCP risk
17 management.

18 In my prepared remarks, I'd like to briefly
19 discuss clearinghouse governance before we begin the
20 more fulsome panel discussions.

21 As background, CME's Clearinghouse maintains
22 a dedicated Clearinghouse Risk Committee which is

1 comprised of market stakeholders, including clearing
2 members, clients, and independent members.

3 In addition to this committee, CME maintains
4 a Clearinghouse Oversight Committee which is comprised
5 of board members of CME Group.

6 The CME Clearinghouse and its senior
7 management team, along with the Clearinghouse Risk
8 Committee and the Oversight Committee of the Board,
9 have dual mandates, to focus on the safety and the
10 efficiency of the Clearinghouse and to support the
11 broader stability of the financial system.

12 The incorporation of these mandates at each
13 level of the Clearinghouse Risk Management and the
14 Governance Committees populated by market stakeholders
15 and the board members is designed to ensure that safety
16 and financial stability are at the forefront of our
17 daily and strategic risk management decisions.

18 These mandates also ensure that every level
19 of the CME Clearinghouse Governance Program, ranging
20 from internal governance by CME Clearinghouse senior
21 management of risk management staff to the external and
22 board level governance provided by the Clearinghouse

1 Risk Committee and Oversight Committee, respectively,
2 and to ensure that it performs its oversight functions
3 with the broader risk management implications of those
4 decisions taking precedence.

5 Additionally, such decisions are transparent
6 to market stakeholders through consultation, through
7 rule changes, through advisories, and such avenues as
8 the public quantitative disclosures.

9 The governance structure of the CME
10 Clearinghouse also focuses on ensuring that a range of
11 market stakeholder views are incorporated into risk
12 management decisions by maintaining the diverse
13 representation on the Clearinghouse Risk Committee.

14 This structure seeks to avoid the potential
15 risks that could result from limiting risk management
16 feedback and input to just a subset of market
17 stakeholders.

18 We believe it is critical to have a diverse
19 and robust input to achieve the best risk management
20 results for the entire market and to ensure that the
21 inherent financial stability benefits of the central
22 clearing market structure, driven in part by a careful

1 balance between defaulter and mutualized resources, as
2 evidenced in past market stress events, are maintained.

3 That concludes my prepared remarks. I would,
4 if it's allowed, like to just make a few comments on
5 the opening statements by my fellow panelists.

6 I do appreciate the thoughts that have been
7 expressed. I also appreciate the work that the FIA has
8 done to produce its thoughts on the CCP risk
9 management.

10 I have to say that as a risk manager of a
11 CCP, I'm in agreement with most of the statements and
12 thoughts as they've been outlined.

13 I do feel like at its whole, though, there is
14 an implication being drawn that incentives between CCPs
15 and its clearing members are misaligned. I don't
16 believe that to be true.

17 CCPs, irregardless of their ownership
18 structure, are completely and 100 percent dependent
19 upon its clearing business for all its revenues. The
20 mutualization of risks are the foundation of the CCP
21 arrangements today and the CCP risk managers working
22 together with the risk managers of its clearing

1 membership are focused on central -- excuse me -- are
2 focused on credit counterparty risk management and
3 should proactively be working together to ensure that
4 risks are managed appropriately.

5 There are no incentives to shortcut risk
6 management for a CCP risk manager because its revenues
7 are dependent upon sound risk management. That
8 incentive doesn't exist. We've seen the dire
9 consequences for getting risk management wrong and
10 continue to focus on improving risk management as part
11 of our daily practice.

12 The FIA is right and as my panelists have
13 said, are right to highlight margin practices as an
14 important focus. We do look to improve our practices
15 in margining as we conduct our risk management.

16 I would say that margin, though, is only one
17 tool in our arsenal for ensuring that we have
18 appropriate risk management in place.

19 As I said, it's important that CCP risk
20 management works with the risk management of its
21 clearing members to proactively monitor the exposures
22 that are being brought into the CCP ecosystem to

1 understand the types of exposures that are being
2 brought, to not just monitor margins but to monitor the
3 portfolios of both its clearing members and the clients
4 of its clearing members, using things like stress
5 testing of those portfolios, to ensure that it can
6 have a view of potential exposures that may result due
7 to changing market situations.

8 In addition to margin, we have other controls
9 that we can use. By understanding those exposures, we
10 can have additional margin. We can add concentration
11 margin, for example, when portfolios get too large,
12 either in absolute terms for the markets that they
13 belong to, or too large for the clearing member itself
14 who's brought those exposures. We can place limits and
15 other controls to ensure that those exposures do not
16 get out of hand.

17 I also think it's right for the focus on
18 default management. After all, the main service that
19 the CCP can provide is that counterparty credit risk
20 management and the ability to be able to liquidate and
21 to be able to liquidate within the financial resources
22 and specifically margins is one of our goals.

1 The CCP, however, is not a market participant
2 itself. It has expertise within its risk management
3 team but is not a market participant and, as such, we
4 are reliant on our clearing member community to be able
5 to support the default management practices and
6 specifically liquidations.

7 The main incentive for clearing members to
8 participate in default management is the guarantee fund
9 contributions which are provided by those clearing
10 members and we must be careful in reaching a balance of
11 the capital provided in the waterfall by CCPs with
12 those contributions of clearing members to ensure that
13 we're not creating moral hazard and that we are
14 incentivizing clearing members to participate and
15 participate well in that liquidation process.

16 So, anyway, those were just a few thoughts on
17 the remarks as they've been said today.

18 I look forward to discussing these and other
19 topics on the panel.

20 Thank you again.

21 MR. STEIGERWALD: Thank you, Lee. Apologies
22 for the missed introduction.

1 I'm reminded that at a recent event at the
2 Federal Reserve Bank of Chicago, one of my colleagues
3 introduced a representative from the private sector, a
4 very young man, as the founder and CEO of the Federal
5 Reserve System, --

6 (Laughter.)

7 MR. STEIGERWALD: -- which would have been a
8 very remarkable thing and would have come as quite a
9 surprise to Jay Powell. So operational risk haunts all
10 of us in all of our endeavors. Apologies again.

11 I turn now to Dale Michaels. Dale, I've got
12 myself flustered here. I have to go back to my list
13 here.

14 Dale is Executive Vice President, Financial
15 Risk Management, at The Options Clearing Corporation.

16 MR. MICHAELS: Thank you, Commissioners, and
17 Alicia Lewis, for hosting this MRAC Panel on
18 Clearinghouse Risk Management and Governance.

19 I am Dale Michaels, Executive Vice President
20 of Financial Risk Management at The Options Clearing
21 Corporation. I have been in risk management for over
22 20 years at different CCPs and therefore welcome the

1 focus of this panel on a topic that is certainly close
2 to my heart.

3 CCPs have performed extraordinarily well
4 during many stressful periods, including the crisis of
5 2008, and it was due to many clearinghouse innovations
6 that have been put in place, including mark-to-market
7 settlements, initial margin models, and default
8 management, to name a few.

9 As a reminder, CCPs do not take on any market
10 risk. We manage the risk. We add a critical risk
11 management function to the financial system and take
12 action when our clearing members are in default, as we
13 did in the wake of Lehman, MF Global, and others.

14 As CCPs have become more critical to the
15 financial industry, as reflected in our designation as
16 distinctly important to financial market utilities, we
17 have endeavored to make our processes even more
18 transparent to the public, with adherence to the
19 principles for financial market infrastructures, and
20 the distribution of both qualitative and quantitative
21 information, so that users can better understand the
22 overall risk management of CCPs and participate in the

1 risk committees and other advisory forums.

2 I'll go through a few of the critical
3 components of the CCP's risk management framework with
4 the first line of defense being the clearing membership
5 itself.

6 At CCPs, we look to have a broad clearing
7 membership that includes all qualified participants,
8 not just the biggest firms, as you want to have a large
9 diversified membership.

10 As an initial matter, OCC considers whether
11 potential clearing members are regulated entities. In
12 the U.S., this means a broker-dealer or a futures
13 commission merchant, and that they are a corporate
14 entity.

15 Most importantly, each CCP continually
16 monitors the credit risk of each of its clearing
17 members that bring exposures to the clearinghouse, are
18 reviewing financial information, the exposures
19 themselves, and market metrics.

20 At OCC, we take this a step further as we
21 perform a risk review of each of our members, both in
22 initial membership and periodically thereafter to

1 ensure that they meet acceptable risk management
2 standards and have appropriate staffing, risk systems,
3 and expertise.

4 The next line of defense is the initial
5 margin. CCPs' initial margin models are distinct from
6 one another to reflect differences in the products and
7 their inherent risk. This prevents model risk involved
8 in using one single approach.

9 Most of the work of CCPs is appropriate to
10 calibrate and review initial margins as conditions and
11 products evolve. This is one of the most critical
12 aspects of what CCPs do.

13 For example, at OCC, we have developed a
14 10,000 scenario, Monte Carlo Initial Margin Calculation
15 Methodology called STANDS, which has put us on the
16 leading edge of risk management.

17 However, CCPs cannot only look at one aspect
18 of a margin model to determine if it's appropriate.
19 For example, to state the initial margin model meets a
20 confidence level of 99.95 percent is meaningless
21 without any context. One must look at the entirety of
22 each specific model.

1 As an example, at OCC, the STANDS margin
2 approach is based on expected shortfall methodology at
3 a 99 percent level, which means that we look at all
4 market observations, including the worst case
5 scenarios, and average those amounts from 99 percent to
6 100 percent on the distribution curve to reflect the
7 tail risk.

8 Most of our other initial margin models will
9 look at precise confidence of 99 percent to calibrate
10 the margin. In both cases, the CCP would state that it
11 meets 99 percent confidence level. However, the OCC
12 expected shortfall method model by definition will
13 always be more conservative as it's incorporating all
14 of the extreme market risks.

15 The margin period of risk, the estimated time
16 needed to close out a defaulting counterparty's
17 accounts is another critical determination in
18 calibrating the appropriate margins.

19 There is a distinction today between
20 exchange-traded derivatives and over-the-counter
21 products in the regulations of a minimum one-day margin
22 period of risk for exchange-traded derivatives and

1 five-day margin period of risk for the OTC products,
2 which reflects the liquidity and complexity of those
3 products.

4 We also believe the margin period of risk
5 should be tied to the default management process, which
6 has also shown that a longer time frame is needed to
7 close out OTC products.

8 While the regulatory minimum margin period of
9 risk for exchange-traded derivatives in the U.S. is one
10 day, the OCC believes that given the default management
11 experience which would likely involve an option process
12 that two days is more reflective of the time frame
13 needed to close out a defaulting counterparty's
14 accounts.

15 The OCC has therefore set the margin period
16 of risk to the more conservative two days for all of
17 its exchange-cleared products. In our view, it's not
18 about the regulatory minimum. It's about what is right
19 for risk management.

20 Another important initial margin aspect is
21 the calculation of margin offsets for correlated
22 products. Many CCPs offer margin offsets for products

1 that are both economically and intuitively linked.
2 These correlations must also be persistent and strong
3 and margin offsets should not be allowed for products
4 that are tangentially correlated or in different asset
5 classes.

6 OCC again has taken risk management a step
7 further in its margin model and runs deep correlation
8 scenarios within its margin model where there's an
9 additional charge at a higher confidence level
10 interval, based on the greater of historical, zero, or
11 perfect correlations of products to cover the risk of
12 markets that may be moving in a much different way than
13 they have in the past.

14 Other considerations in reviewing margin
15 models include daily calibrations, length of look-back
16 periods, liquidity and concentration add-ons, wrong way
17 of risk, intraday margin capabilities, just to name a
18 few.

19 So in considering the universe of margin
20 models, it is never relevant to look at just one aspect
21 of the margin model but to look at the margin models in
22 their entirety.

1 The next level of defense is the current
2 funds themselves. Much of what CCPs have in place for
3 initial margin also applies to stress testing of
4 clearing funds as CCPs look to size those funds at the
5 appropriate level.

6 These include having a robust number of
7 scenarios, deep correlation scenarios, and long look-
8 back periods. The regulatory minimum in the U.S. is a
9 Cover 1 standard, meaning that the CCPs can cover
10 exposure of its largest clearing member firm. OCC also
11 exceeds this regulatory standard and have implemented a
12 Cover 2 standard which covers the largest two clearing
13 firm exposures.

14 Generally, CCPs look at bringing many similar
15 products in the clearing fund and default waterfall to
16 allow them to be risk managed together. While a
17 clearing member may not clear each and every product in
18 their waterfall, we want to have broad participation in
19 a CCP clearing fund rather than have small silo funds
20 for single products.

21 If there is a small silo fund, there is no
22 recourse to other financial resources for those funds.

1 A CCP default is much more likely, which would
2 obviously be much more damaging to the customers, to
3 clearing firms, and the entire system.

4 And the last thing, the risk framework, is
5 default management. CCPs have worked closely with
6 clearing member firms and with other CCPs to have
7 robust default management processing, especially with
8 regards to the option process, that allows the CCP to
9 return to a matched book. This includes a vigorous
10 default management testing on the option process that
11 includes wide participation for both clearing member
12 firms and clients.

13 For some options, it's necessary to have
14 mandatory participation so that CCPs can have many
15 viable bids, which would allow for the best outcome for
16 the market, although most importantly in the default
17 management process and any stressed market environment,
18 is for the CCPs to retain the flexibility to be able to
19 react to the facts and circumstances at the time as the
20 next stress event will likely be much different than
21 the last stress events.

22 As a systemically-important financial market

1 utility, OCC remains committed to serving as a
2 foundation for secure markets and to ensuring
3 confidence in the financial markets and broader
4 economy.

5 We will continue to invest in solutions that
6 enhance our resiliency and fortify our operational
7 effectiveness to reduce systemic risk across the global
8 financial markets.

9 Thank you very much for your time and
10 consideration and look forward to further questions.

11 MR. STEIGERWALD: Thank you, Dale.

12 Our final panelist speaking this morning is
13 Tyson Slocum. He is Director of the Energy Program at
14 Public Citizen.

15 Tyson, your remarks, please.

16 MR. SLOCUM: Great. Thank you so much.

17 Good morning, everyone. I just want to thank
18 Commissioner Behnam for his leadership on the Market
19 Risk Advisory Committee, for Alicia Lewis for all of
20 the tremendous amount of work that you and others have
21 done to put this together, and I appreciate the
22 opportunity to serve with my fellow panelists and with

1 my fellow Market Risk Advisory Committee members.

2 So Public Citizen is a consumer advocacy
3 group, so we try and represent the interests of
4 household consumers in a variety of different areas.
5 We've got over 400,000 such household members that help
6 finance the operations of Public Citizen and we try and
7 represent the public interest.

8 The financial crisis of 2008 resulted in
9 domestic and international efforts to enhance risk
10 management, improve transparency, and heighten market
11 integrity with requirements for more transactions to
12 move through central counterparties. These clearing
13 requirements have assigned significant public interest
14 functions to the companies performing central counter-
15 party duties.

16 So it is therefore prudent for the CFTC to
17 ensure that both the ownership structures, the legal
18 and regulatory obligations, the transparency of
19 operations of these central counterparties are aligned
20 for maximum protections for members, commodity end
21 users, and the public interest.

22 The CFTC's oversight of central counterparty

1 governance and transparency is guided by core
2 principles and these core principles are very broad and
3 the CFTC actually attempted to dive in and provide a
4 lot more detailed requirements in proposed rulemakings
5 in 2010 and 2011 that ended up not going anywhere.

6 And so as a result, efforts to codify and
7 strengthen those rules remain incomplete, and I think
8 one of the outcomes of the discussions we're having
9 here today would be for the Commission to revive
10 rulemaking efforts, particularly on governance,
11 transparency, and conflict of interest of central
12 counterparties.

13 Such efforts could include explicit standards
14 for compositions of boards of directors, disciplinary
15 panels, risk management committees addressing the role
16 of members on risk management committees.

17 We heard from JP Morgan about certain
18 specific requirements under EU rules that do not exist
19 under CFTC rules and so I do think a proposed rule-
20 making to address certain aspects of the operations of
21 these risk management committees would be helpful.

22 Ensuring that incentives between central

1 counterparty business models, including all their
2 affiliate interactions and their members and end users
3 and the public interest, are all properly aligned, I
4 think ensuring a measure of independence of the risk
5 management committee from the board of directors would
6 be helpful, and stronger reporting requirements to
7 address potential conflicts of interest.

8 So thank you very much for your time and I
9 look forward to any questions.

10 MR. STEIGERWALD: Thank you very much.

11 At this time, I'd like to offer the panel an
12 opportunity to comment on what has been said so far. I
13 think it would be very helpful to the further
14 discussion by the committee to hear your thoughts about
15 what was said by your fellow panelists.

16 MS. ROSENBERG: Robert, thank you. I'll just
17 make a couple of remarks, comments.

18 So the first thing I would say is JP Morgan
19 has a hundred memberships over 60 clearinghouse groups.
20 So I think it's important that the comments that I
21 presented really represent our views across our CCP
22 portfolio and the exposures that we have.

1 Now the largest exposures, of course, are
2 towards the largest CCP groups and we spend a lot of
3 time focused on the risk management, the transparency,
4 and the governance around those groups. So I just want
5 to make that as a general statement.

6 In respect to some of the comments, the
7 remarks that were provided, I would just reiterate a
8 couple of things.

9 One is that clearinghouses do take risk. So
10 I think that's a really important point to emphasize.
11 They make decisions every day that affect individual
12 clearing members, clients, and the market overall. So
13 they are making decisions about risk management that
14 could create, you know, risk down the road and I think
15 that's important.

16 The other thing I want to say is about
17 governance. So with respect to governance and
18 particularly around clearinghouses engaging with
19 members and their clients around decisions or material
20 changes that could affect ultimately the capital the
21 clearing members contribute to the default fund,
22 there's no one size fits all approach. So every

1 clearinghouse has a different approach.

2 Some from a communications standpoint are
3 very -- start engaging very early on in design process
4 through risk member, risk working groups, and this is a
5 very effective way to genuinely get member input, not a
6 check off the box, but genuinely engage with the
7 membership community, get input and that input then
8 gets discussed at the formal risk committee that
9 ultimately helps shape any proposed rulemaking, whereas
10 other CCPs tend to -- when we sometimes find out about
11 changes, they're actually through public -- I would say
12 rule filings where members can provide public comments
13 and we think that way is not as constructive.

14 So those are the couple of comments I would
15 make. In addition to transparency, I would say the
16 CPMI Osco Quantitative Disclosures are very helpful to
17 the market but we don't think that they go far enough
18 and we do believe again across the portfolio that we
19 have of CCP memberships some clearinghouses are better
20 than others in sharing information that we can
21 therefore evaluate our risk and it really varies across
22 the spectrum, and I would encourage the CFTC and other

1 regulators to continue to have these discussions about
2 encouraging clearinghouses to share information, even
3 on a bilateral basis, with their members that hold a
4 lot of the risk, even if it's through NDAs,
5 confidentiality agreements.

6 I sit intentionally within the independent
7 risk management structure at JP Morgan. We are the
8 private side of the organization and we contain any
9 information we receive within our function.

10 Thank you.

11 MS. CRIGHTON: I'll just add a few more
12 comments to Marnie's.

13 The first thing I think Lee you highlighted
14 this and it was in my comments, as well. I think the
15 notion of FCMS being risk managers alongside CCPs is an
16 important one and I think they are very much aligned
17 and I think two things of that sort of brings up as
18 areas of focus and we've touched on those but I think
19 it's worth highlighting them again is (1) the
20 governance around membership criteria.

21 I think because we are risk managers
22 alongside of each other, you know, in the instances

1 where self-clearing participants are going direct to
2 the CCP, they don't have the buffer of another XCM
3 performing that risk management role. So as an
4 industry, we are relying on the CCP to perform those
5 risk management obligations.

6 I think the second piece in there is the
7 setting of margin and the transparency and the detail
8 of information provided around setting of margin.

9 I'm not sure as an industry we've necessarily
10 solved for the right level of transparency and the
11 communication with, I think, the broader community. I
12 think closely tied to that, and, Dale, you touched on
13 the setting of margin period of risk, I think it's
14 incumbent on all of us, I think, to strengthen the
15 relationship between stated MPOR and initial margin,
16 so, and I think more work needs to be done there.

17 And the last piece that I'll just touch on is
18 the default management proceedings. I think again more
19 work to be done in regards to member input,
20 particularly to enhance the liquidation proceedings. I
21 think balancing the amount of information that's given
22 to whether it's the option participants or the default

1 management committee, the composition of that
2 committee, I think are all areas that we should be
3 discussing further.

4 Thank you.

5 MR. STEIGERWALD: Thank you, Marnie and
6 Alicia.

7 I must say just from my own perspective,
8 those comments help shape more generally your approach
9 to some of the issues that have come up. From my
10 perspective, when I saw some of the issues that were
11 listed by MRAC committee members as topics for concern,
12 at a first blush, you might well ask yourself whether
13 the system works at all, there are so many issues to be
14 addressed, and yet it does.

15 In fact, it works well enough that the
16 leaders of the G20 decided to make it an important
17 component, it being central clearing, of the Financial
18 Stability Program for the world.

19 Marnie, your remarks in particular point out
20 that there is some diversity of practice globally and
21 in different parts of the industry addressing
22 particular asset classes, particular markets, and

1 that's important for us to remember, as well.

2 Dale and Lee, would you like to make further
3 comments, based on what you've heard?

4 MR. MICHAELS: Sure. So this is one of those
5 items that I think we are in agreement with the
6 comments here as far as including the current
7 membership and others as far as the overall governance
8 process.

9 I mean, it would be silly not to. These
10 folks have experts in the industry that could help us
11 out. Never think that we have the monopoly of experts
12 on clearinghouse risk management.

13 So at our organization, at OCC, we do have a
14 financial risk advisory council. This is made up of
15 clearing member firms and clients. We bring all model
16 changes, clearing fund changes, default management
17 processes through that body and that body has a direct
18 link to our risk committee, so that everything that's
19 discussed, any issues that are brought up are then
20 summarized to the risk committee themselves and they
21 could act on or if they decided not to act on, we bring
22 it back to that council to give them the decision as

1 far as to why it wasn't. So I think there is that
2 process in place at some CCPs.

3 I'd say the one thing that I also want to
4 comment on is the default management process. We
5 certainly need to engage with the clearing member
6 firms. I mean, we practice this at least once a year,
7 if not multiple times a year, at CCPs. It is that
8 important to get the operational pieces of this down so
9 that folks can know when they're planning a portfolio
10 how to bid, what is the information that they're
11 looking at.

12 I would say there is a little bit of tension
13 here between what I'm hearing sometimes in these types
14 of forums as far as wanting to participate in default
15 management versus what you have when you talk to the
16 actual desks who are providing bids.

17 When we are going through the default
18 management process, a lot of the times we are not
19 getting their attention and we don't get that type of
20 cooperation. In some cases, we have to -- when we
21 don't get that cooperation, we have to take action and
22 bring it to our risk committee and fine these members

1 because they have not participated, even though they
2 realize it is critical that we have this process in
3 place.

4 So, you know, there is that balance that has
5 to be struck, as well.

6 MR. BETSILL: Yeah. Thanks. Let me just
7 address a couple of the points that have been raised
8 here.

9 You're right, Robert. There's been a lot
10 that I've thrown out there and despite it all, we do
11 actually function on a day-to-day basis in the clearing
12 space.

13 If I can address the comment on the self-
14 clearing membership that Alicia raised, on this topic
15 and as Commissioner Berkovitz pointed out in his
16 opening statement, diversity of membership is important
17 in the clearing infrastructure and ecosystem.

18 The market itself benefits from having a wide
19 range of participants in its markets, from
20 institutional hedgers, commercial hedgers, to
21 speculators and retail clients. We benefit from that
22 large eco-structure and that does take a

1 diversification of the membership.

2 Now the majority of CCP business on the
3 clearing side is conducted through FCMs or client
4 clearing business, but the proprietary trading firms
5 also is a very big and important part of the clearing
6 infrastructure, and I would point out that our largest
7 self-clearing members are in fact the large banks who
8 also own FCMs.

9 Due to capital pressures, we've seen a number
10 of banks become self-clearing members, and I don't
11 think there's anything inherent riskier about those
12 self-clearing members.

13 As Dale pointed out in the membership
14 criteria, we need to ensure that all of our members can
15 support the clearing business that they bring into the
16 CCP. They need to have the operational capacity. They
17 need to have the independent risk oversight, and we
18 need to work with those clearing members just like our
19 client clearing firms on ensuring that the exposures
20 that they bring into the CCP are commensurate with
21 their own financial resources and the levels that they
22 can support, and it's not just capital levels, right?

1 One of the things that we look at is the form
2 that that capital takes. Liquidity risk is a very
3 important part of the clearing ecosystem in that we are
4 running daily mark-to-markets, in our case for futures
5 and options twice a day, running a variation margin
6 settlement, which requires flows of money.

7 So we need to ensure that the firms have the
8 right form of capital to be able to meet increases in
9 margin calls and the changing market infrastructure.

10 So, you know, everybody can get risk
11 management wrong from time to time. It's how we're
12 able to react to that and to the changing situation and
13 I don't think that self-clearing members are inherently
14 riskier than other clearing members and indeed that we
15 benefit from having smaller clearing members in the
16 ecosystem.

17 Could I also just make a couple of points on
18 governance? I started out in my opening statement on
19 governance but Tyson has raised it. It's been a theme
20 here.

21 I think at least at CME, the composition of
22 our risk committees, the composition of our board is

1 set out to ensure that there is both a wide-ranging
2 input and experiences and that there is the appropriate
3 challenge and oversight by the board.

4 So our risk committees are rather large. I
5 think our clearinghouse risk committee for futures and
6 options is 16 members strong and the majority of those
7 are from clearing members. So we do get very much the
8 clearing member view.

9 People have raised the question of NDAs for
10 committee members. Those are important when we are
11 bringing early discussions on potentially
12 competitively-sensitive material, but the majority of
13 what we bring is not commercially-sensitive.

14 I'll take the example of enhancements that
15 CME is making to expand margin model. We have been
16 consulting on a bilateral basis with our market
17 stakeholders for more than a year and a half now.
18 We've done hundreds of bilateral meetings. We've
19 discussed in forums. We have operational and risk
20 working groups looking at the new model and all of that
21 is input into the risk committee decision to move
22 forward with what will be a material change.

1 It also has to go through our board
2 committee, the approval. We need to bring the views of
3 the market as a whole, the views of the risk committee,
4 and to get approval from the board to move forward with
5 a material change.

6 And, lastly, of course, we need to get a
7 regulatory approval for those types of material
8 changes. So for us, these enhancements to our margin
9 model is a multiyear process of ensuring that we get it
10 right.

11 I'll stop there. Thanks.

12 MR. STEIGERWALD: Thank you, Lee. I think
13 it's appropriate for us now to invite participation by
14 MRAC members and to start off, Alicia, you introduce --

15 MS. LEWIS: Well, I know the tent cards are
16 about to fly. So we're going to go to the phone first
17 so that we'll be able to get the views of the members
18 on the phone.

19 Is there anyone on the phone that would like
20 to make a comment or has a question?

21 MS. YARED: Hi, good morning, Alicia. This
22 is Rana from Goldman. I would like the opportunity, if

1 you please.

2 MS. LEWIS: Yes, the Chair recognizes Rana
3 Yared of Goldman Sachs.

4 MS. YARED: Thank you.

5 So echoing to some of the comments that were
6 made by the distinguished panel, we want to amplify
7 just a few points on behalf of Goldman Sachs.

8 First, as an institution, we view well-
9 functioning risk committees to be those that allow a
10 high degree of direct clearing member participation and
11 which make decisions that are based not on what is most
12 commercially expedient for a CCP but, rather, what will
13 be viewed as prudent risk management of the clearing
14 members and, indeed, the clearinghouse's own capital.

15 It is for that reason that we believe that
16 clearinghouses having appropriate amounts of skin in
17 the game aligned interests. In the same way that we
18 don't wish to lose our capital as a non-defaulting
19 member, we assume that the clearinghouse will be more
20 incentivized to make the strongest and most robust risk
21 management decisions if the consequences for not doing
22 so are having their own capital at risk.

1 Secondly, we want to make sure that in
2 discussions about CCP best practices that we avoid
3 alluding to risk management standards being different
4 between listed and OTC products.

5 We view riskiness as not a function of the
6 product form but, rather, as a result of liquidity,
7 volatility, market concentration, and expected
8 availability of hedges and the timing of those hedges
9 for an effective default management process.

10 If a clearinghouse applies for a short MPOR
11 to the products that it clears, the onus should indeed
12 be on the clearinghouse to demonstrate that the margin
13 is appropriate and sufficient. This case should also
14 be supported with a suitable amount of additional
15 clearinghouse skin in the game capital and, further,
16 this support should be furnished to the relevant risk
17 committees previously mentioned by the speakers on the
18 panel to get appropriate input from not only direct
19 clearing members but also independent members of the
20 risk committee.

21 We believe, further, that idiosyncratic risks
22 should be housed in segregated default funds and

1 referred to our previous views around the appropriate
2 segregation that we seek of OTC swap products and our
3 views around the need for segregation of crypto assets.

4 Finally, while we wish for some degree of
5 certainty in respect of the rulebooks, we want to
6 acknowledge that being overly-prescriptive limits the
7 range of options that clearinghouses and default
8 management groups have in a default scenario in a
9 manner that could potentially cause further losses.

10 To that end, we believe it is important that
11 default management groups, which are the groups that
12 are endowed with the ability to actually hedge the book
13 in a default scenario, sometimes they're an employee of
14 the clearinghouse, sometimes it is a group that is
15 drawn from the membership, has the flexibility that it
16 needs to react to market conditions and the
17 peculiarities of each default.

18 One of the previous speakers said that the
19 next default won't look like the one that happens
20 directly before it and we think it's very important to
21 not write the rulebooks that falls to the default that
22 we just saw but, rather, that provides the

1 clearinghouses and the DMPs and the risk committees
2 which oversee them with a toolkit that has the
3 appropriate tools to handle the next default.

4 With that, thank you for the opportunity to
5 speak to the group.

6 MS. LEWIS: Thank you, Rana.

7 Is there anyone else on the phone that has a
8 comment or question?

9 MR. MURPHY: Hi. This is John Murphy with
10 Commodity Markets Council.

11 MS. LEWIS: The Chair recognizes John Murphy
12 from Commodity Markets Council.

13 MR. MURPHY: Thank you, Alicia, appreciate
14 it, and thank you to the panel for your comments.

15 I just had a quick question that anyone on
16 the panel can answer, and it pertains to the default
17 management process and again without being too
18 prescriptive around the auction process, I think that
19 what we do need is more transparency around the auction
20 process.

21 I think we saw recently in Europe with the
22 default on the exchange in Europe that there were

1 issues with the number of participants involved in the
2 auction process, which probably caused some additional
3 market stress that was unintentional.

4 But what do you think a process would be from
5 an auction perspective that would be more reasonable
6 and more resilient on a go-forward basis without
7 causing more market stress if you are in the midst of a
8 market environment? So does anyone have any opinions
9 on what the appropriate auction process really should
10 look like?

11 MS. LEWIS: The Chair recognizes Lee Betsill,
12 CME Clearing.

13 MR. BETSILL: Thank you, Alicia, and thanks,
14 John, for the question, and Rana, as well. I think
15 both of you touched on similar topics as it comes to
16 default management.

17 Liquidation is difficult, right, to get
18 right. There is a balance always in having enough
19 participants to be able to support a good auction in
20 the sense that you get the best prices and telegraphing
21 the positions that you're about to unload on the
22 market. You can go too wide.

1 So it is a difficult thing to get right. I
2 think Rana pointed out that there should be a
3 difference in the default management approach between
4 OTC contracts and listed contracts and I think that's
5 right.

6 In the listed markets, we do have the benefit
7 of an order book of more liquid products which can be
8 utilized in the default management process, making
9 hedging or liquidation more efficient from the CCP
10 standpoint.

11 Whereas, I think most CCPs who offer OTC
12 markets utilize their risk committees or default
13 management committees to be able to advise a CCP on the
14 best method for liquidation and that usually involves
15 analyzing the portfolio and suggesting hedges which can
16 be put on before the OTC positions are liquidated and
17 the primary tool for that is via auction, given that we
18 don't have an order book that we can go to in the CCP.
19 So I'm agreeing with that.

20 I think to the transparency point that you
21 raised, John, we try to get this right, as Dale pointed
22 out, by having regular default management drills,

1 liquidation drills. We practice this regularly with
2 our membership to get the operational elements right
3 and also to ensure that everyone knows what sort of
4 action the CCP will be taking in the auctions.

5 The results of those default management
6 drills are subject to extensive write-ups in our case.
7 We share those and discuss those with our risk
8 committees and get feedback on how we're doing with
9 those drills, but it's basically to get the community
10 comfortable with what will happen should we have a
11 default and we do try to be transparent about that.

12 On transparency generally, I'll just state to
13 close that, of course, we do regular due diligence
14 visits with our clearing members, all of them, and
15 that's both the CCP looking at the risk practices of
16 our clearing members to ensure that they continue to
17 meet membership requirements, but it also comes the
18 other way. So clearing members perform due diligence
19 visits on the CCP and we try to be as transparent as we
20 can with our practices in those types of visits,
21 including over our default management practices.

22 I'll stop there.

1 MS. LEWIS: Thank you, Lee.

2 The Chair recognizes Kristin Walters,
3 BlackRock.

4 MS. WALTERS: Thank you very much. Thanks,
5 Commissioner Behnam, for raising the important issue of
6 CCP resiliency, and to the panel, I share many of the
7 views that were discussed.

8 I think the recent NASDAQ default highlights
9 BlackRock's kind of longstanding and public views that
10 steps need to be taken to improve CCP resilience, both
11 to reduce systemic risk as well as to prevent loss
12 allocation to end investors who BlackRock represents on
13 a fiduciary basis.

14 Just wanted to highlight a few issues, one,
15 skin in the game, which a number of folks have spoken
16 about this morning. Incentive alignment continues to
17 be a very real problem. Both regulatory requirements
18 and market practice have resulted in skin in the game
19 that does not appropriately align incentives for CCPs
20 who benefit from the clearing mandate and we believe
21 that the recent loss allocation may have been avoided
22 in its entirety if the CCP had more skin in the game.

1 It's important to point out that we're not
2 just advocating for more skin in the game but we'd like
3 to see the relevant regulatory bodies just develop a
4 robust and defensible framework for assessing and
5 applying appropriate levels of skin in the game going
6 forward.

7 Around exchange rate versus OTC markets, the
8 OTC derivatives markets have benefited by margin
9 adequacy methodologies that are more risk-sensitive as
10 well as enhanced default risk management -- sorry --
11 default management procedures. Those changes have not
12 been made on the exchange-traded side and certainly
13 we've seen that liquidity can be an issue in both
14 markets and we are advocates for similar changes to be
15 made to legacy margin methodologies on the exchange-
16 traded side as well as default management practices.

17 Definitely, we believe that disclosure
18 standards need to be improved. Many of the risk
19 management shortcomings that were revealed by the
20 recent CCP loss allocation were not readily apparent
21 from their disclosures and, in fact, CCP disclosure
22 requirements continue to be less than some of the

1 smallest public companies in financial markets.

2 Finally, just with regard to protecting end
3 users and taxpayers, just to note that the MGH
4 continues to be captured in CCP rulebooks and we would
5 like the regulators to address this issue. We do not
6 think that it is -- we do not advocate for the MGH
7 being used by CCPs and if used at all with some
8 caveats, it should only be in the instance of
9 resolution.

10 I would just note that everything that I
11 said, we've been saying, you know, as part of -- I've
12 been saying on behalf of BlackRock for the last several
13 years, on MRAC. They're not new ideas. They're just
14 basic best practices around risk management and
15 governance that we think need to evolve in this space.

16 I would ask folks to reflect on the buy side
17 perspective on CCP risk that we presented, Angela Patel
18 from Putnam, Bill Thumb from Vanguard, and I presented
19 a few years back on the back of the recommendations we
20 made to SIFMA AMG. We feel those recommendations are
21 still -- we still support them.

22 And, finally, a couple of viewpoints that

1 BlackRock has written on the topic of CCP resiliency.
2 One, back in 2016 and then very recently, we put our
3 thoughts together on an end usage perspective on
4 central clearing 10 years post financial crisis. It
5 addresses many of my comments today as well as the
6 views of folks on the panel.

7 So thank you very much.

8 MS. LEWIS: The Chair recognizes Bis
9 Chatterjee, Citigroup.

10 MR. CHATTERJEE: Alicia, thank you for the
11 opportunity to ask a question, just a question, not a
12 statement.

13 It seemed like the discussion initially was
14 focusing on, most of you, that there could be best
15 practices that various CCPs follow that could be shared
16 across the CCP ecosystem and that people could take on.

17 But, you know, based on statements and
18 comments, it almost seems like, well, no, there are
19 areas where it doesn't apply.

20 Lee, you mentioned that the default
21 management and the liquidation of a portfolio for OTC
22 and listed could be very different.

1 So I'm curious to hear from the panelists
2 like where do you think, what areas you think best
3 practices can be, you know, transported from listed to
4 OTC markets or vice versa. Is it in the softer areas
5 of governance, transparency, or is it for, you know,
6 margin and option method?

7 And, Dale, you mentioned that, you know, you
8 aren't sticking to the prescribed minimum regulatory
9 and you're focused more on risk approach for MPOR.

10 You know, Lee, you mentioned your reliance on
11 listed markets for liquidation but, you know, we all
12 know in stress markets, even listed markets can be thin
13 and, you know, block markets may exist over here from
14 the listed markets.

15 So I'm curious to hear like where do you
16 think these best practices can be extended and where
17 they fall apart.

18 MS. LEWIS: The Chair recognizes Dale
19 Michaels from OCC.

20 MR. MICHAELS: Sorry. I got a little
21 aggressive there.

22 I think when you look back at when the rules

1 were put in place, there was a definite economy between
2 OTC and exchange trading. They were very different.
3 We just started on the OTC products. There wasn't a
4 lot of visibility into them.

5 I think as these markets have developed and
6 we've looked at the standards, I think there is
7 starting to see some coalescing around, you know, one
8 broader risk management -- I'll just take an example of
9 default management, one of my favorites.

10 When you look at what we put together for the
11 OTC types of products, it was mandatory default
12 management groups, mandatory participation in the
13 drills, and if there are actual defaults that occur.
14 The juniorization and seniorization of clearing firm
15 for those that participate well or not so well.

16 I think when you look at what has been put in
17 place for exchange-traded, there wasn't that mandatory
18 types of actions. You look at what's been occurring
19 more recently, many CCPs have put into place mandatory
20 testing. Some CCPs are looking at mandatory
21 participation exchange-traded if you are clearing the
22 product.

1 So you can kind of see it starting to morph
2 into that direction as far as let's take the best
3 practices that are out there and get it into the one
4 best practice rather than keeping this perhaps
5 sometimes artificial dichotomy and figuring out what is
6 the best approach.

7 So I think I'm starting to see it certainly
8 in default management. I think you're starting to see
9 it elsewhere as well as far as risk management and
10 margin models. I think the margin models on the
11 exchange-traded side were developed at a point in time.
12 I think they are advancing to probably more of the
13 sophisticated margin models that we're seeing today,
14 whether they be far or expected shortfall, things along
15 that line.

16 MS. LEWIS: Actually, I have to recognize
17 Marnie first. Marnie Rosenberg.

18 MS. ROSENBERG: Thank you. I'm just
19 responding to Bis's question from our perspective where
20 we think there could be best practices.

21 One, which I can't emphasize enough is
22 greater transparency, sharing full documentation on

1 margin and stress testing, as we said, because members
2 bear most of the risk through the default fund.

3 A few other areas in margin which I think --
4 which have been developed primarily in the OTC space
5 which could -- really should be thought through more on
6 the listed side is appropriate concentration add-ons.
7 So in the swaps space, we, as well as other members,
8 participate in liquidity surveys into the CCP.

9 I would say on the listed side, what we see
10 across our portfolio is not as much of a robust
11 concentration in liquidity add-on framework, which
12 really should be based on average daily volumes and
13 should be transparent to the market.

14 The other area we see which is growing in
15 adoption which we support is utilizing a stress margin
16 framework. So when clearinghouses calculate stress
17 losses above margin, consideration more broadly should
18 be for requiring those members that bring stress loss
19 to the market to pay more in margin.

20 And then the other thing I would say which
21 Alicia did mention is on capping liability to members.
22 The only way we can effectively manage our risk to the

1 system is having an effective cap on our liability.

2 MS. LEWIS: Lee Betsill, CME.

3 MR. BETSILL: Thanks, Alicia.

4 Can I just go back to the best practices
5 remarks or question that Bis asked?

6 We do in the CCP community attempt to share
7 best practices. Dale and I are both members of CCP-12.
8 There's each in Europe. There's the Post Trade Working
9 Group at WFE. We do get together and attempt to share
10 best practices.

11 A good example was just last week in
12 Singapore in association with the FIA meeting last
13 week. There was an event organized by CCP-12 to share
14 and do some training on default management and auction
15 practices and as a group, we offered that to CCP-12
16 members to come and learn more about how others do it.

17 So we do make an attempt, despite being in a
18 competitive environment, we do make an attempt to share
19 best practices with the thought in mind that if we
20 raise the standards across the board that's good for us
21 all.

22 Oh, and by the way, on the NASDAQ default,

1 the NASDAQ has, as I think most of you know, undertaken
2 an independent study to look into what happened there
3 and NASDAQ have let us know that within the CCP
4 community, they will share the results of that
5 independent study and use that as a best practices
6 platform for further discussion.

7 MS. LEWIS: Thank you, Lee.

8 The Chair recognizes Laura Climpel from BPCC.

9 MS. CLIMPEL: Thanks, Alicia.

10 I just wanted to pick up on one of the points
11 Marnie raised regarding the fact that at least in
12 certain cases JPM's view is that the quantitative
13 disclosures of certain CCPs don't necessarily go far
14 enough in terms of what the CCP is able to disclose
15 about the exposures the market participants have vis a
16 vis the CCP and I think it's just important to raise
17 that in terms of the CCPs' obligation to be as
18 transparent as possible with its members in terms of
19 helping them manage the exposure they have to the CCP,
20 there's always a tension in terms of what we can
21 actually disclose without violating our obligation to
22 keep commercially-sensitive information and

1 transaction-level information of our market
2 participants confidential.

3 So I think that definitely there's probably
4 more that can be done to strike a middle ground to
5 provide more information, at least in certain cases, in
6 terms of what the CCP's able to disclose, but I don't
7 think that a non-disclosure agreement or any other sort
8 of bilateral agreement between a CCP and a market
9 participant would work for that purpose.

10 I think if there's going to be additional
11 transparency and potentially sharing of confidential
12 information with market participants, even in a
13 controlled function, I think the norms around how that
14 information would be shared and how it would be
15 controlled would have to be multilaterally agreed by
16 the CCP and its membership.

17 MS. LEWIS: Thank you, Laura.

18 The Chair recognizes Salman Banaei, IHS
19 Market.

20 MR. BANAEI: Thank you. Thank you, Alicia.
21 Thank you, Commissioner Behnam, for facilitating this
22 important conversation.

1 I just had a couple comments. First, under
2 the header of diversity and competition in these
3 markets, so that's a theme that's very much consistent
4 with the value that we provide the markets as a leading
5 authorized trade processor at all the major
6 clearinghouses.

7 We provide economies of scale as it relates
8 to both trade processing which encourages competition
9 and stability at the trading and at the clearance
10 level.

11 In addition to the value of diversity among
12 market infrastructures, there's also diversity in the
13 methods used in stress testing in particular and one of
14 the things I've noticed out there, OFR last year, about
15 a year ago, published an interesting paper where they
16 looked at the network of exposures across the CVS
17 markets and they looked at OTC as well as clear CVS
18 exposures and they found that the leading clearinghouse
19 was maybe not as robust to systemic shocks as a similar
20 CFTC stress test that was published a year earlier
21 suggested.

22 So that might be an area where the

1 Commission, given its data that it can see across both
2 cleared positions and OTC positions, can provide some
3 additional value and some validation or critique of the
4 OFR paper.

5 And then, secondarily, the topic of skin in
6 the game has come up repeatedly at this MRAC meeting as
7 well as past ones.

8 One suggestion I had in looking at papers on
9 systemic stability that have come out of the financial
10 crisis is perhaps there should be a layer of debt
11 capital that comes before we get to the guarantee fund
12 that would be issued by the CCP and it would be
13 unsubordinated debt. It would be reissued
14 periodically, often enough so that you could do a
15 proper mark-to-market of it.

16 It would both reduce the cost for the CCP to
17 provide that additional layer of debt capital because
18 the CCP would only be providing interest payments and
19 then it would also provide regulators in the
20 marketplace a market-based measure of what the CCPs',
21 you know, riskiness might be.

22 MS. LEWIS: The Chair recognizes Chairman

1 Giancarlo.

2 CHAIRMAN GIANCARLO: Thank you, Alicia.

3 I just wanted to respond to the reference you
4 made to that OFR study and I wouldn't want members to
5 come away thinking that we didn't look at that very
6 carefully because we did.

7 I don't have our chief economist here but our
8 Office of Chief Economist looked at it and perhaps at
9 another meeting, we might have them speak to it, but we
10 had major issues with their conclusions, some of their
11 fundamental understanding of how our markets work was
12 incorrect, and so perhaps at another meeting we might
13 have that, but I wouldn't want anybody to think we
14 didn't look at it carefully because on its face it
15 would contradict our own studies but in fact we found it
16 to be deficient quite substantially in basic
17 understanding of how clearing in our markets work. But
18 perhaps at another meeting, if it's appropriate, we can
19 speak to that so that the committee can understand
20 where our differences lie.

21 MR. BANAEI: If I can just react to that
22 very quickly, and I appreciate that and not to imply

1 that, you know, that analysis wasn't undertaken, but I
2 think as a member of the public, some transparency
3 around that or dialogue back and forth would be a
4 helpful thing.

5 CHAIRMAN GIANCARLO: I think we should do it.

6 MS. LEWIS: Okay. We have 10 minutes. So
7 I'd like to give Suzy, then Lindsay, and then Demetri,
8 and then, oh, Kristen, where are you? You left. Okay.
9 I want to get the people who haven't spoken yet, and
10 then go to the phone really quickly, and then I'll come
11 back to those who have spoken.

12 So the Chair recognizes Suzy White.

13 MS. WHITE: Thank you, Alicia. Thank you,
14 Commission's Chairman, for prioritizing this important
15 topic.

16 I'd like to bring the panel back to stress
17 testing, if I may, and I think all the opening points
18 were very helpful. A number of you mentioned stress
19 testing.

20 We believe stress testing is at the core of
21 any effective risk management framework and I
22 appreciate the visibility that the CCPs give as to the

1 results of the stress tests. I wonder, though, should
2 more visibility and potentially input be given to the
3 actual scenarios and the shocks that are run and also
4 to the jump-off points from which we start the
5 stresses, what market conditions we consider.

6 I agree with Marnie's point that the CP
7 assessors disclosures are in stepping in the right
8 direction but still believe more transparency into this
9 area could help us collectively strengthen risk
10 management.

11 MS. LEWIS: Thank you, Suzy.

12 The Chair recognizes Lindsay Hopkins.

13 MS. HOPKINS: Thanks, Alicia, and I should be
14 able to make this very quick.

15 My comment is on the governance side. There
16 were a few calls earlier today for more clearing member
17 representation in governance, particularly at the risk
18 committee level, and I obviously think that perspective
19 is very valuable.

20 It also depends upon the support and
21 involvement of clearing members in the process. I
22 think there's some recognition that there's already a

1 limited pool of experts and qualified individuals when
2 it comes to CCP issues. So then when you have a small
3 exchange like us that already has a limited pool, it's
4 really even smaller.

5 So it just makes any kind of expectation or
6 best practices in terms of representation or
7 composition of committees really difficult. So we
8 appreciate the flexibility that's in the current
9 regulations to determine the best governance
10 arrangements, committee composition, and both of your
11 comments on flexibility, as well.

12 MS. LEWIS: Thank you, Lindsay.

13 The Chair recognizes Demetri Karousos.

14 MR. KAROUSOS: Thanks, Alicia. I'll keep --

15 MS. LEWIS: I'm sorry. From Nodal Exchange.

16 MR. KAROUSOS: Thanks, Alicia. I'll keep my
17 comments brief.

18 Just wanted to start by saying Nodal
19 Exchange, for those of you don't know us or familiar
20 with us, we are a commodity exchange in North America.
21 We are the second largest commodity exchange for power
22 futures. So we represent roughly 30 percent open

1 interest in power trading. So, of course, the events
2 in Europe were of particular interest to us and have
3 had numerous conversations with our clearing members
4 and so this is all very fresh, of course, for us.

5 We welcome the recommendations that have come
6 from FIA and from the clearing members regarding best
7 practices, partly because we think we already capture
8 most of those best practices. So whether it's directly
9 incorporating concentration risk into the margin
10 requirements for all the portfolios, we've been doing
11 that since launch, or whether in terms of taking on the
12 procyclicality risks, Marnie, that you mentioned, we
13 look back to up to 10 years for specific risk scenarios
14 to particularly capture that because, as you know,
15 we've been through a relatively low period of
16 volatility recently and if you just jump into that
17 volatility, you will see your margin model react,
18 unless you capture some of that prior historical risk.

19 So while we welcome all of that, I just want
20 to echo the theme of flexibility and not being overly-
21 prescriptive. So two areas, for example, that we would
22 caution, we are quite familiar with the average daily

1 volume formula used by some clearing members and by
2 some clearinghouses to calculate liquidity margin or
3 concentration margin. We don't think that's a good
4 calculation. We think average daily volume is more
5 reflective of day trading and in and out trading rather
6 than what we prefer to use, which is a share of open
7 interest.

8 So just in that particular example, I think
9 having the flexibility to determine what the
10 appropriate way to manage concentration risk should be
11 left up to the clearinghouse, and there was another
12 thing I was going to mention but I forgot already.

13 And then my broader point, I don't want to
14 preempt the findings of the default NASDAQ. We
15 certainly don't know all the facts and so I don't want
16 to preempt anything there.

17 I just would highlight that when those
18 recommendations do come out, based on our conversations
19 that have already occurred, our insight is that not all
20 recommendations are created equally. So for us, the
21 membership requirements were a particular concern in
22 that scenario and likewise the way the default itself

1 was handled.

2 So we still need to learn more. We still
3 need to understand the overall details and facts, but
4 my suspicion is that what we've already gleaned is that
5 not all the recommendations are as important as others.

6 So thank you for your time and thank you for
7 attention to this important discussion.

8 MS. LEWIS: Thank you, Demetri.

9 The Chair recognizes Commissioner Berkovitz.

10 COMMISSIONER BERKOVITZ: Thank you, Alicia.

11 There have been a number of comments this
12 morning, Lee and Dale, and I think, Salman, you talked
13 about the importance of wide and diverse membership for
14 the clearinghouses, and in light of that and I've seen,
15 Robert, you have -- on a number of other occasions,
16 I've seen your diagrams about the advantages of
17 clearing and all the radial lines going to the various
18 members that support clearing.

19 So my question is, how concerned should we be
20 now when we see some of these numbers like the FSB is
21 reporting that five clearing members have 80 percent of
22 certain markets, like interest rate swap markets?

1 We're down to a handful, literally a handful of
2 clearing members have about 80 percent of the market,
3 and is there a point at which there's too few clearing
4 members to support clearing? Are we anywhere near that
5 or how do we make a judgment on the robustness of the
6 process with so few members?

7 MS. LEWIS: Lee, your card is still up. You
8 want to take that?

9 Lee Betsill, CME Group.

10 MR. BETSILL: Yeah. Captured.

11 Yeah. To answer the question, I do think
12 there's such a thing as too few clearing members. We
13 do benefit from having a diverse set of clearing
14 members. I would make the point that there is a large
15 area of difference between OTC-cleared products and
16 listed cleared products.

17 We find that in the listed business, there
18 are a lot more clearing members and there are a lot
19 more clearing members providing client clearing and so
20 just want to make that distinction, but I agree with
21 your fear that there could be too few firms providing
22 client clearing and we should be looking as an industry

1 to enhance things like capital rules for banks to
2 ensure that there are a diversification and enough
3 clearing members offering services to clients that we
4 can achieve things like porting of clients should there
5 be a clearing member default.

6 MS. LEWIS: The Chair recognizes Dale
7 Michaels, OCC.

8 MR. MICHAELS: Thank you.

9 I think you bring up a great point here. You
10 know, coming back years ago, we had well over a hundred
11 clearing members. Those are dwindling over time.
12 That's why we are very cognizant to try to bring in
13 clearing members that may not be the largest of the
14 large members.

15 These smaller members, if they are
16 appropriately risk-managed, if we are making sure that
17 they have the adequate staffing, the systems, the
18 capabilities, that they are also bringing in clients
19 that just won't be cleared by the clearing members.
20 They may not have the client capabilities that the
21 larger members don't want to have.

22 So they are bringing in diversification to

1 our industry. We need to have more of these members.
2 You mentioned the concentration risk. You talk about
3 settlement banks are the same thing. We don't have
4 large diverse settlement banks. We are reaching out to
5 get more settlement banks because there is a
6 concentration of settlement banks.

7 You talk about custodial services as well in
8 the industry. We keep on going on and on where we keep
9 on reaching out and trying to find other ways to
10 balance out the concentration risks.

11 So I don't want to get into this thing as far
12 as, okay, if large is the only one that's good, there
13 has to be a balance in here, and just because there
14 might be smaller members that I don't want to equate
15 this to what happened with the clearing member default
16 at NASDAQ where that was a direct participant. That's
17 a little bit different than just saying it was a small
18 member.

19 We should encourage smaller members to reduce
20 some of the concentration risk as long as we as the
21 CCPs are looking at the financial metrics that they
22 have, looking at the exposures that they're bringing,

1 we're looking at the systems, the staffing, and their
2 capabilities.

3 MS. LEWIS: The Chair recognizes Lee Betsill.

4 MR. BETSILL: Thank you, Alicia.

5 I did want to circle back to the topic that's
6 been raised by a number of committee members, skin in
7 the game. It seems to be a theme throughout the
8 conversation today, and I'd like to thank the committee
9 member for suggestions on potentially looking at new
10 forms of taking skin in the game.

11 That being said, I do think that it is an
12 important tenet of a CCP that it does have an
13 appropriate level of skin in the game and that that
14 skin in the game is first loss.

15 A number of you have pointed that out and I
16 just wanted to be clear that the CME anyway is very
17 much in agreement with that. It should be first loss
18 and it should be in a form which is immediately
19 recognizable or it can be fed into the system.

20 When looking at an appropriate amount of skin
21 in the game, I want to go back to my comments in the
22 opening that it needs to be large enough to incentivize

1 the clearinghouse to get its risk management practices,
2 its risk management practices right, but not too large
3 that it disincentivizes clearing members from
4 participating in a productive and efficient way in the
5 default management process.

6 So where that level is is a difficult thing
7 to pinpoint, but I think when assessing the size of
8 skin in the game that a CCP has, it's not appropriate
9 to look at the aggregate amount of the guarantee fund.
10 It's more appropriate to look at the amount that's
11 being contributed by its clearing members. It is first
12 loss or should be first loss before going into the
13 mutualized guarantee fund and it should be at a level
14 which is commensurate with the amount of contribution
15 that its clearing members bring and that amount of
16 allocation, if you will, of those contributions to
17 clearing members should be in alignment with the size
18 of the exposures that that particular clearing member
19 is bringing into the system.

20 Thank you.

21 MS. LEWIS: Thank you, Lee.

22 Are there any members on the phone with

1 additional comments or questions?

2 (No response.)

3 MS. LEWIS: Well, the final comment and
4 question of the day goes to Kristen Walters of
5 BlackRock.

6 MS. WALTERS: Thanks very much.

7 Just a final comment around skin in the game
8 and so, you know, if you think about the recent NASDAQ
9 default, just bear in mind that NASDAQ is a publicly-
10 traded holding company with \$14 billion in market
11 capitalization and so I don't think it's unreasonable
12 to ask CCPs of that size and strength from a capital
13 perspective to provide reasonable amounts to a default
14 fund rather than potentially having losses allocated to
15 end users.

16 Thanks.

17 MS. LEWIS: Well, that concludes our very
18 lively discussion of Clearinghouse Risk Management and
19 Governance Today.

20 Thank you to our facilitators and our
21 panelists and our MRAC members who participated and at
22 this time, in keeping with the meeting agenda, we will

1 break for lunch.

2 For those of you who are not familiar with
3 the area, we do have lunch options on the agenda table.
4 Should you wish to bring your lunch back, you're able
5 to have lunch in our employee lounge and Bob Wasserman
6 has graciously baked two cakes for the MRAC meeting.

7 (Applause.)

8 MS. LEWIS: And everyone knows that Bob's
9 cakes are not to be missed. So the Wasserman cakes
10 will be put out at 12:55.

11 So we will adjourn now for lunch and then be
12 back at 1.

13 Thank you so much.

14 (Lunch.)

15 MS. LEWIS: It is my pleasure to call this
16 meeting back to order.

17 And now we'll have the second panel of the
18 day, Non-Default Losses in Recovery and Resolution.
19 Isaac Chang of AQR Capital Management is the
20 facilitator of this panel.

21 Isaac is the Managing Director and Co-Head of
22 Trading of AQR Capital Management and in this role,

1 he's responsible for managing the firm's trading
2 operations across all asset classes and regions as well
3 as ensuring the firm's execution strategy response to
4 and address with changes to the market structure and
5 regulatory landscape.

6 He's a member of AQR's internal committees
7 dealing with market and liquidity, operational,
8 counterparty, and technology risk. He also sets the
9 direction and priorities for trading, technology
10 initiatives, including order management, execution, and
11 analytics, and he's also a member of the MRAC, as well.

12 So we're very happy to have you and thank
13 you. I'll turn it over to you.

14 Panel 2: Non-Default Losses in Recovery and Resolution

15 MR. CHANG: Great. Thanks, Alicia. Thank
16 you.

17 I'll start by thanking Commission Behnam and
18 Alicia also for focusing on this area of clearinghouse
19 risk and putting this meeting together and also to the
20 Chairman and Commissioners Stump and Berkovitz for
21 their support.

22 So I have the privilege today of introducing

1 and then facilitating the second panel of the day. We
2 also have the distinction of being the first panel
3 after lunch. So, first and foremost, we'll do our best
4 to try and keep people from slipping into a food coma.

5 Generally, when market participants discuss
6 and debate clearinghouse risk, the focus is on what
7 happens in the case of market participant is unable to
8 make their margin requirements and defaults.

9 Indeed, it might seem overly-clear that
10 managing the risk of a clearing member is a CCP's core
11 function. However, the topic of this panel is non-
12 default losses, both generally, but also specifically
13 in recovery and resolution.

14 This is an area that, at least based on my
15 observation, is discussed much less frequently and
16 where formal rules are relatively less clear.

17 These losses can be characterized in three
18 broad buckets: first, losses from business or
19 operational failures, second, losses from investments,
20 and third, losses from custodial failures.

21 Business or operational failures can cover a
22 very wide range of outcomes, cyber attack, fraud by a

1 CCP, internal technology failure, a regulatory issue.
2 Investment or custodial losses relate to the initial
3 margin that clearing members post. This margin can be
4 in the form of cash or securities and when cash is
5 posted, the CCP invests cash based on its investment
6 policies, often set in consultation with clearing
7 members, and a loss on those investments would reduce
8 the value of the clearing member's margin and require
9 the clearing member to provide additional assets.

10 When members post non-cash initial margin
11 that is deposited with an approved custodian. The
12 failure of a custodian could lead to either delay in
13 getting access to this margin or potentially even the
14 loss of a clearing member's non-cash margin.

15 CPMI IOSCO in their 2016 paper, Resilience
16 and Recovery of Central Counterparties: Further
17 Guidance on the PFMI, stated that "A CCP shall identify
18 the amount of its own resources to be applied towards
19 losses arising from custody and investment risk to
20 bolster confidence that participant's assets are
21 prudently safeguarded."

22 Additionally and perhaps in contrast, it says

1 that a CCP should hold sufficient liquid net assets
2 funded by equity that it can continue its operations
3 and services as an ongoing concern after a business
4 loss.

5 CPMI IOSCO paper also argues that the general
6 business losses should be the responsibility of a CCP
7 while it might be reasonable to share custody and
8 investment risks between the CCP and its members.

9 In practice, however, as our panelists will
10 discuss, policies and practices vary across
11 clearinghouse families and regulatory guidance actually
12 also varies between geographies.

13 The issue of non-default losses can be
14 further complicated if they occur simultaneously with
15 default losses. Additionally, what happens when the
16 loss is catastrophic or large enough to consume all
17 available resources?

18 I think these questions just scratch the
19 surface of the myriad of issues that arise when we
20 start to delve more deeply into the topic.

21 With that, let me turn to my distinguished
22 panelists. I'll introduce each one and they'll give

1 their initial statement before we proceed.

2 So, first, we have three representatives from
3 clearinghouses, then one from a clearing member, and
4 finally one from a buy-side end user.

5 So let me first introduce Teo Floor, Systemic
6 Risk Policy Advisor at Eurex Clearing and give him a
7 chance to give his opening statement.

8 Teo, the floor is yours.

9 MR. FLOOR: Thank you very much.

10 I would like to thank the CFTC, its staff,
11 and Commissioner Behnam for the opportunity to speak on
12 this important topic.

13 We are strong supporters of the public
14 discourse the MRAC fosters, which is essential for the
15 thoughtful challenge and debate that maintains trust
16 and prudence in our markets.

17 My name is Teo Floor, and I represent a CCP
18 based in Frankfurt, Germany. We are a CCP under EMIR
19 as well as a credit institution with its applicable
20 regulations in the EU.

21 While the European Union has not finalized
22 its recovery and resolution legislation, this is in an

1 advanced stage and the European Parliament has
2 finalized its position earlier on this year, and we
3 expect that this will be very much in line with the
4 considered recovery and resolution work developed by
5 CPMI IOSCO.

6 Non-default losses are for CCP a humbling
7 topic. While recovery and resolution for member
8 default scenarios highlights the ability of centralized
9 risk managers to rematch and recollateralize markets
10 undergoing the most extreme scenarios, the non-default
11 losses are concerned not with resolving the market
12 crisis but facing our own failures.

13 This distinction is crucial as non-default
14 losses are those scenarios in which the CCP has a
15 matchbook and its members are alive and well. It is
16 thus a question of how resilient the operator of the
17 CCP is and how centrally-cleared markets can be
18 continued with minimal disruption should the operator
19 need to be replaced.

20 This also makes clear the difference of
21 incentives that are key to minimizing the likelihood
22 and the impact of non-default losses. While in member

1 default cases, participants require both extant
2 incentives for accepting the costs of prudent
3 collateralization and the in situ circumstances to
4 support the CCP rebalancing the market, for non-default
5 losses, it is the CCP which requires both forms of
6 control and restraint.

7 Of course, with CCPs exposed to varying
8 degrees of their clearing members or affiliate
9 companies for supporting services and the links between
10 certain types of non-default losses and market stress,
11 there are joint member default and non-default loss
12 scenarios.

13 A proposed approach to such events is to
14 tackle the member defaults first and then the non-
15 default losses if they cannot be separated or managed
16 simultaneously.

17 It would not make much sense to recover the
18 CCP operator if the markets it served were unviable and
19 their continuation was either undesirable or
20 impossible.

21 The second conceptual point, both in terms of
22 fairness but setting incentives, is that as a rule, the

1 CCP should bear the losses for non-default losses.
2 There is one major exception to this, which is for
3 those non-default loss types which relate to the
4 cleared markets themselves.

5 Our approach is that all non-default losses
6 are solely our responsibility to manage and should the
7 unlikely situation ever arise cover ourselves. Any
8 loss-sharing with participants must be explicitly
9 described in our rulebook, subject to consultation with
10 regulators.

11 In our view, this creates a suitable
12 governing arrangement for clarifying responsibility.
13 In particular, CCPs hold cash and non-cash collateral
14 from their members and risks which affects these must
15 be in some cases shared with the participants.

16 If a non-default loss would encumber the
17 collateral, then the cleared market would no longer be
18 intact as the open positions are uncovered. As such,
19 the non-default loss is not one which the change of
20 operator would cure.

21 There is also the practical consideration
22 that it would be wholly uneconomical for a CCP operator

1 to underwrite the full collateral pool of the markets
2 it clears.

3 For this particular case, our rulebook is
4 similar to that of many CCPs. For those currencies we
5 receive that we cannot deposit at central banks,
6 following a tranche of CCP equity, further losses in
7 that currency would be allocated to participants who
8 gave it to the CCP.

9 While much of the public sector and industry
10 debate has focused on these demarcation questions, most
11 of our time on non-default loss work consists of
12 improving our resilience and validating and challenging
13 our operations and defining the various categories of
14 non-default losses.

15 Thank you, and I look forward to your
16 questions.

17 MR. CHANG: Thanks, Teo.

18 Next, we have Eric Nield, General Counsel of
19 ICE Clear Credit.

20 MR. NIELD: Thank you, Isaac.

21 I'd like to take this opportunity to thank
22 the Commissioners, thank Alicia Lewis for putting

1 together this meeting today, and discuss these
2 important topics and allowing ICE to participate in
3 these discussions. I thank you.

4 As Isaac mentioned, I'm the General Counsel
5 of ICE Clear Credit. We are a clearinghouse regulated
6 in the United States, focused on the clearing of over-
7 the-counter credit default swaps. We are also part of
8 the larger Intercontinental Exchange Group. We have
9 six regulated clearinghouses across five different
10 regulatory jurisdictions.

11 We spend a significant amount of time at ICE
12 coordinating across our clearinghouses for consistent
13 practices, despite at times differing local
14 regulations. Non-default losses is no exception to
15 this coordination and we do our best to make sure
16 things are consistent, unless there's a regulatory
17 reasons that they're not.

18 You know, echoing Teo's comments, in terms of
19 business and operational risk, clearinghouses are
20 responsible for their business operations, their
21 technology, etcetera, and we are responsible for any
22 losses resulting from those activities.

1 Just like any other business, we are liable
2 for our business and operational losses. If that was
3 the end of the discussion, it would be a quick panel,
4 but there are a couple exceptions to this general rule
5 and that is in the context of investment losses and
6 custodial losses.

7 If you think about what a clearinghouse does,
8 a material effect of its business is to collect
9 significant assets from its clearing members in the
10 form of margin and guarantee fund deposits to support
11 their cleared positions.

12 ICE Clear Credit is not a bank, is not a
13 custodian. We cannot -- we don't have the option of
14 simply holding these assets. We need to rely on third
15 parties to provide services and also third parties as
16 investment counterparties.

17 In this activity, there's significant
18 constraints on what we can do with these assets due to
19 regulations which are appropriate given the systemic
20 risks involved.

21 If central bank depository services and
22 custodial services are available, they should be fully

1 utilized. That type of access largely mitigates these
2 custodial investment losses facing clearinghouses, but
3 to the extent that central bank access is not
4 available, CCPs must rely on commercial banks and
5 custodians.

6 So there's options. What happens if there's
7 a loss related to those services provided by these
8 commercial institutions? Can I go through a few of the
9 options to just compare and contrast?

10 It's not uncommon when you use the services
11 of a third party that's outside of your control to
12 disclaim responsibility for those third party
13 activities, absent violation of some standard of care,
14 fraud, negligence, willful misconduct. So there is an
15 argument the clearinghouse could disclaim liability for
16 third party service providers and that's not
17 inconsistent with similar actors within the financial
18 system.

19 At the other extreme, clearinghouses could be
20 fully responsible for the activities of these third
21 party actors, regardless of whether there's a breach of
22 any type of standard of care. This would in effect

1 make clearinghouses the guarantor of these highly-
2 regulated financial institutions. That's a position
3 that may impair the resiliency of clearinghouses.

4 A middle ground, and this is the position
5 advocated by CPMI IOSCO, is that there's some sharing
6 of this liability and that the clearinghouses assume a
7 first loss liability layer prior to mutualizing to the
8 clearing members. This is an approach that's supported
9 by ICE and this essentially is not -- there is an
10 absence of regulation in this area with one exception I
11 know of. So this essentially is a business decision at
12 this point of the clearinghouse to assume this first
13 loss layer.

14 ICE, as I mentioned, has multiple
15 clearinghouses. Some of them have this type of loss
16 layer in place already. Other clearinghouses are
17 actively working with local regulators to put that type
18 of first loss liability in place.

19 Another related topic which, when we're
20 talking about non-default losses that I think is
21 important to keep in mind, is the capital resources
22 available at the clearinghouse to pay for any type of

1 liability. Depending on what jurisdiction the
2 clearinghouse is sitting in, regulatory capital
3 requirements can be very different.

4 For example, in the U.S., you have
5 essentially a 12-month projected operating expense
6 capital requirement imposed on CCPs. In Europe, you
7 have EBA standards for capital requirements and those
8 calculations can come out to very different results.
9 So depending on what jurisdiction you're in, you may
10 have regulatory requirements that are very different
11 about what resources are available to ensure the
12 resiliency of the clearinghouse and when talking about
13 non-default losses and talking about liability for non-
14 default losses, I think it's important to also bring in
15 the analogist concept of CCP capital requirements.

16 I'll leave my comments at that. I thank you,
17 and I welcome any questions you may have.

18 MR. CHANG: Thanks, Eric.

19 That brings us to Dennis McLaughlin, Chief
20 Risk Officer of LCH Group Limited.

21 MR. McLAUGHLIN: Thank you for the
22 opportunity of addressing the Commission today.

1 It's probably worth taking a step back and
2 just see how this all fits into the scheme of things.
3 The so-called default losses are traditionally what
4 CCPs have to manage and they were set up for to handle
5 the member default, the default of the clearing member.

6 There are other losses, however, that are not
7 directly related to that that you incur when trying to
8 carry out that function. So, for example, you have to
9 take margins that the members give you and find a home
10 for them because you're not allowed to keep it on
11 deposit at a commercial bank, for example, which is
12 very wise but what do you do with them?

13 Well, there are all sorts of regulatory
14 constraints about how you can invest that margin. For
15 example, you can keep -- under EMIR, you can't have
16 more than five percent invest unsecured. So what do
17 you do with the rest of it? You have to go to the repo
18 market, unfortunately. So you're exposed to investment
19 losses in order to fulfill your function to have the
20 margin ready in the event it's needed to cover a member
21 default.

22 Now if you have access to a central bank in

1 the relevant currency, then you can just pass through
2 the money that the client gives you directly into the
3 deposit account and you can avoid taking that
4 investment risk and, indeed, that's what we do in the
5 para-CCP where it is a financial institution, has full
6 access to the European financial system, and therefore
7 we don't incur investment risk in the same way.

8 However, in London, in our London
9 clearinghouse, we manage 22 different currencies and,
10 of course, we don't have deposit accounts in each of
11 those currencies. Most notable is the U.S. So we're
12 forced into the repo market and to manage the
13 investment activity in that way, so that our liquidity
14 profile is such that we can have enough money to cover
15 the default of a clearing member.

16 What I would say about that is it can be also
17 mitigated in many ways. Probably the easiest way to
18 mitigate that is to make sure you have a very narrow
19 high-quality list of collateral that you would accept
20 so that you do not experience a deterioration in the
21 credit quality of that collateral. That's the primary
22 defense.

1 The Bank of England a few years ago
2 introduced regulations or it's a statutory regulation
3 where they forced such a clearinghouse to have a loss
4 allocation procedure agreed with its members and so we
5 indeed have that in place where we take a skin in the
6 game and above that skin in the game, the investment
7 losses are shared out among its members. That's the
8 primary way that we handle losses from investments at
9 LCH.

10 The other biggest ones are when an ICSD
11 fails, so we've heard about the custodian failing, with
12 a custodian, we have legally-segregated collateral. We
13 don't have to have a default of the custodian. We just
14 have to have an operational problem and therefore it
15 will be difficult to get our hands on the collateral in
16 order to then turn around and turn it into cash.

17 So it is legally segregated. That's probably
18 a very big risk that we have to manage, but if the
19 custodian is in trouble, then it's a market-wide issue,
20 it's not just us, because many people are using these
21 custodians.

22 The same with an ICSD, the settlement

1 platform. The biggest example I can think of is
2 probably EuroClearing in Europe where it's the
3 mechanism by which we breathe in the market which turns
4 securities into cash and which we all then get the cash
5 that we so want.

6 If there's an operational failure there, then
7 we'd have a delay in getting our hands on that cash and
8 there could be some slippage in the market.

9 So these are primarily the largest kind of
10 non-default losses that we face. People have also
11 asked about cyber. Cyber is a non-default loss. It
12 fits into the general operational losses category and
13 we would agree, of course, that for such losses, it
14 comes down to the clearinghouse capital at the end of
15 the day.

16 The biggest risk in cyber is really the
17 margins that our clients, our members give us need to
18 be protected against the hack, for example, and if you
19 have that locked down, which it is possible to do, then
20 any resulting losses would be very quickly detected
21 because each account is being reconciled by up to three
22 to four different institutions several times a day. So

1 we would detect an anomaly in the data from a hack
2 very, very quickly and then it's all about resetting
3 the clock to the most recent fresh good dataset and
4 running on from there and since we're subject to the
5 two-hour recovery, we're talking a small number of
6 hours to recover from a cyber attack.

7 So there will be defenses, if you like, that
8 we have in place to cover the major types of non-
9 default losses.

10 I'll stop there.

11 MR. CHANG: Thank you, Dennis.

12 So now we move from clearinghouses to
13 clearing members.

14 Next up us Bis Chatterjee. He's Managing
15 Director and Co-Head of Electronic Trading and
16 Automated Market-Making for the Global Spread Products
17 Group at Citigroup.

18 Bis.

19 MR. CHATTERJEE: Thank you, Isaac.

20 At the start, I'd like to acknowledge
21 obviously Commissioner Behnam, sponsor of the MRAC, for
22 giving us this opportunity. I'd like to thank the

1 Chairman, the other Commissioners of the CFTC for their
2 continued support for making this forum successful.
3 Finally, thanks to Alicia for her tireless efforts,
4 including yesterday when she was trying to juggle two
5 calls successfully for prepping the panelists.

6 So starting at a high level, you know, as
7 acknowledged by the other panel members, non-default
8 loss or NDL as it's referred to is described as losses
9 sustained by clearing ecosystem from sources other than
10 related to the positions of a defaulted clearing
11 member.

12 I'd like to stress ecosystem and not CCP
13 because I think these losses could be borne by the CCP.
14 These could be suffered by the clearing members and
15 they could be suffered by our clients.

16 Sources of NDLS, you know, Isaac mentioned
17 three sources. I'd like to add a fourth one. So first
18 is obviously investment of collateral. Second is, you
19 know, failure of financial services provider. A third
20 is operations, IT, cyber or fraud. The fourth loss
21 which I can identify is, you know, that maybe resulting
22 from unexpected monetary downside from fines or

1 regulatory actions. That can sometimes be a
2 significant source of NDL, as well.

3 So before we, you know, jump to the topic and
4 move to identifying who's responsible and allocating
5 these losses, I would really like to emphasize that,
6 you know, our view on NDL is, you know, it's an
7 unnecessary loss and our focus should really be on
8 trying to prevent NDL and the responsibility of
9 preventing NDL should be the entire responsibility of
10 the ecosystem, whether it's CCP management team, the
11 clearing members, or the clients.

12 For example, in the case of cyber, you know,
13 a lot of times the attack or the hack may come from the
14 extended ecosystem and find its way to the
15 clearinghouse. So the clearinghouses may have in place
16 very robust, you know, defenses but it's always the
17 weakest link that exposes, you know, the system to
18 NDLs.

19 And as we enter into, you know, this age of
20 rapid technology and operational innovation, we're
21 obviously opening the door to such threats. As a
22 result, you know, we feel that transparency, having an

1 open dialogue with the CCP and its members, and
2 spreading the awareness about NDLS, the source of NDLS,
3 and how such NDLS can be prevented should be the focus
4 of our discussions across the industry.

5 When it comes to responsibility of NDLS and
6 the associated loss allocation from these above
7 sources, I think there's various issues that are
8 involved in trying to identify, you know, who are the
9 parties that were making these specific choices that
10 led to these NDLS? Were there available alternate
11 options? You know, I think some of my fellow panelists
12 mentioned that in some cases, like custodian banks,
13 there aren't that many options available.

14 The transparency that was provided to the
15 members and our clients about, you know, these choices
16 that have been made, whether they're investment,
17 whether they're custodial, and if there was any
18 financial upside from making these choices regarding
19 investment decisions, who was bearing the benefit of
20 these upsides? So I think a lot of these factors will
21 go into deciding who bears the loss and how these
22 losses would be allocated?

1 So depending on the issues associated with
2 the cause of these losses, you know, the NDL could be
3 broadly borne by the clearing members and the end
4 users, the CCP, or jointly by the CCP and its
5 membership. You know, to generalize, I think when
6 clearing members make distinct choices, like those
7 related to investments, it's probably fair that, you
8 know, these members bear some of these losses because
9 especially if they were earning the benefits of
10 choosing a certain type of collateral investment and,
11 you know, earning that return.

12 Similarly, losses where CCP day-to-day
13 management operations are resulting from choices made
14 by the CCP management, it might be possible to point
15 those losses back at the people making such decisions.

16 And where, you know, the CCP activity relies
17 on third party custodians, third party service
18 providers, and where, like I mentioned, these service
19 providers on their end in an abundance of caution for
20 you to make these choices or transfer as you sense a
21 weakening, these losses could possibly be borne jointly
22 across the system.

1 Finally, where do we get the resources for
2 clearing NDLs, and I think on this point, we feel
3 strongly that resources for NDLs should be distinct
4 than those that are available for clearing member
5 default.

6 The current default management framework,
7 whether it's the IM or the guarantee fund models, do
8 not include any factors for modeling of NDLs. So it
9 would be probably not wise to directly jump into and
10 start using the default management funds to clear NDLs.

11 So rather than combine these two complex risk
12 models, we think it's probably better to consider
13 modeling the NDL losses and therefore coming up with a
14 source of resources separately.

15 At the same time, we have to recognize that
16 additional resources, if they are kept against losses,
17 obviously add cost to the clearing system. So if we
18 choose to explore options on separately resourcing and
19 funding such NDLs, we should also be cognizant about
20 whether we can be creative about creating the source of
21 these funds for NDL, whether they should be funded or
22 unfunded, such that the costs of such resources are

1 appropriately borne.

2 With that, I'd like to close and thank you,
3 everyone.

4 MR. CHANG: Thanks, Bis.

5 So now we hear from a buy-side end user of
6 clearinghouses.

7 Eileen Kiely is Managing Director from
8 BlackRock. Thanks, Eileen.

9 MS. KIELY: Thank you, Isaac, and thank you
10 very much to the Commission for inviting BlackRock here
11 today to provide these thoughts.

12 Before I make my comments, I'd like to remind
13 those listening, since I know this is being webcast to
14 whoever is listening, that I am sitting here as a
15 fiduciary today on behalf of BlackRock's clients.

16 BlackRock itself does not take any economic
17 risk to central counterparties and our comments today
18 are entirely aimed at what we think is best for the end
19 investor. These are investors who are saving for their
20 educations and retirement across the globe and in order
21 to comment on non-default losses, I think we must first
22 start with our position on default losses, which will

1 help frame our view on the NDL.

2 Default losses should not be allocated to the
3 end investor unless it is done so by a resolution
4 authority. This position rests on the premise that
5 central counterparties are in the business of credit
6 risk mitigation. They offer the service of credit risk
7 mitigation for a fee and I think we'll all agree this
8 has proven to be a very profitable business and I think
9 we cannot lose sight of that as we continue to regulate
10 this industry.

11 If a CCP fails in its provision of credit
12 risk mitigation, then it itself should be allowed to
13 fail and if the resolution authority finds it in the
14 public interest for the central counterparty to
15 continue operating, then that resolution authority
16 should allocate losses accordingly.

17 Any losses paid by the participants in this
18 process should be refunded out of future profits of a
19 reconstituted central counterparty.

20 So given this position on default losses, I
21 think our position on non-default losses is fairly
22 straightforward. At no point should non-default losses

1 be passed to the end investor, whether they are
2 corporate losses, investment losses, or third party-
3 related losses, such as custodial failures.

4 I will justify this position by addressing a
5 very reasonable connection between decision-making and
6 loss-bearing.

7 As an end investor, we have no say in how the
8 central counterparty uses our clients' cash or
9 securities. We rely on the various client money rules
10 around the globe that generally provide protection
11 against inappropriate investments, but the investment
12 decision is ultimately made by the central counterparty
13 or, in some cases, our clearing member.

14 Similarly, the choice of custodian or payment
15 bank is usually made by the central counterparty or the
16 clearing member. We expect these entities as our
17 service providers to fully vet and risk manage the
18 third parties they select.

19 In that regard, we believe the current legal
20 framework may be too ambiguous about how clearing
21 members may be able to allocate losses to investors.
22 Standard industry documentation tends to provide

1 intermediaries with pretty broad leeway to pass losses
2 on to their clients.

3 So as we collectively strive to enhance the
4 safety and soundness of our markets, we think this is
5 something that should be reviewed closely.

6 Thank you for your attention, and I look
7 forward to the discussion to follow.

8 MR. CHANG: Thanks, Eileen.

9 So maybe I'll kick off the discussion with a
10 question for the panelists.

11 So given the current state of both the key
12 differences among how clearing -- details on how
13 clearinghouses handle non-default losses and given the
14 somewhat unclear regulatory framework, maybe an obvious
15 question to ask is, does the industry need more
16 prescriptive and clear regulatory guidance to ensure
17 the appropriate policies for handling NDLs across
18 clearinghouses?

19 MR. McLAUGHLIN: I can at least take a stab
20 at answering that.

21 Obviously the answer is yes, but I think
22 there's something we can do immediately, which is we've

1 been doing it now for a few years, is to start
2 expanding the scope of the fire drills we've run
3 outside of regular traditional default losses into non-
4 default loss scenarios.

5 So this is something that's kind of been done
6 in a very disorganized way already by most CCPs in the
7 sense of the IT department would run a cyber loss
8 scenario. There might be a fraud scenario run by the
9 finance group, but if you bring it together, you can
10 quickly see that there is some trends here that you can
11 really -- or weaknesses that you can isolate.

12 So, for example, we've run scenarios on an
13 ICSD being in trouble, not defaulting but just being
14 troubled, because of the operational and the liquidity
15 implications of that can shed a lot of light on how we
16 run it as an operation. So just those kind of
17 exercises.

18 Another one would be a cyber event. So we've
19 done several of those. For example, an instantaneous
20 default in the normal sense, just called at random,
21 things like that unannounced, we've done a lot of those
22 things to test the resilience and to test the controls.

1 So I would say that it would be very helpful
2 if there was a way that we could expand fire drills to
3 mean fire drills for non-default losses, which is
4 something we should do anyway.

5 MS. LEWIS: The Chair recognizes Eileen Kiely
6 from BlackRock.

7 MS. KIELY: Thank you.

8 So I think I'd like to make a comment that
9 ties together what we were talking about earlier this
10 morning and that's the importance of just a capital
11 framework for CCPs in general.

12 I think non-default losses and default losses
13 need to have more stringent -- a more reasoned and
14 thoughtful foundation upon which capital should be held
15 against them.

16 So, you know, non-default losses have --
17 default losses have a more stringent approach right
18 now. Non-default losses are much further behind, but
19 they both really do need to have a more fulsome
20 approach by the regulatory community.

21 MS. LEWIS: The Chair recognizes Teo Floor,
22 Eurex Clearing.

1 MR. FLOOR: Thank you.

2 I would agree with Dennis that, yes, of
3 course, we'd need further sort of regulatory guidance
4 on the matter. I mean not only because it relates to
5 how we're covering how resolution is handled in
6 general.

7 So in Europe, that's still an ongoing
8 discussion. I think that for NDL cases which
9 potentially bring the whole CCP down, of course, there
10 there's an important question of who our resolution
11 authority would be in Europe and how they would
12 interact with our supervisors if they're not the same.

13 I would contend that there is quite a lot of
14 commonality in how CCPs actually approach the topic.
15 So from that perspective, I'm not sure whether there's
16 too much divergence in how it is handled in practice.

17 The one question, of course, which stands out
18 is the ability of different CCPs to access different
19 central banks or different CSDs and I think that that's
20 an area which, of course, is very controversial. It's
21 not one that we can ourselves, I think, tackle.

22 So I think that's an area where if regulators

1 decide what they want the ability of CCPs to access
2 central banks to be, then it becomes relatively easy to
3 make sure that we all have sort of commonality in how
4 we treat any potential sharing of those NDL losses.

5 MS. LEWIS: I want to open up the floor for
6 questions and comments, but I'm going to go to Chairman
7 Giancarlo first.

8 CHAIRMAN GIANCARLO: Thank you.

9 I thought Isaac's question was a good one,
10 and I find it remarkable that at least three of the
11 respondents immediately said government response is
12 necessary.

13 I would have thought that just good
14 enterprise risk management practices, good risk
15 mitigation controls within your own firms would have
16 led to a way of addressing this before we need to get
17 to prescriptive approach from regulators. Is that not
18 the case? Is that not the case? Good risk management
19 at CCPs would have led to a first step before
20 regulators need to come in with a prescriptive approach
21 to handling that?

22 MS. LEWIS: Okay. So where do I start?

1 We'll start with Bis Chatterjee.

2 MR. CHATTERJEE: I think the Chairman, he
3 stole my thunder a bit because I was going to respond
4 to the previous question.

5 Certainly, I think it's very hard to see the
6 market asking for more regulation. So I think, you
7 know, there's a whole spectrum. We start with
8 guidelines and move to policy and then maybe
9 regulation, and I would kind of put this discussion and
10 this topic in the kind of guideline phase, and I think
11 there are a couple of things that can easily address
12 this issue.

13 Transparency. I think Teo mentioned about,
14 you know, their clearinghouse have it very clearly laid
15 out in their rulebooks. I think that would be the
16 first guideline as good management practice every CCP
17 or the clearing ecosystem could follow.

18 I think the challenge with NDLs is it's
19 something that takes everyone by surprise. No one
20 expected an NDL and therefore ends up with an NDL and
21 therefore we're all scrambling trying to figure it out.

22 So I think transparency, you know, better

1 clarity would definitely solve a lot of these issues.

2 Going back to resources, capital, you know,
3 as it is with market risk, credit risk, we're having a
4 challenging time trying to identify the right capital
5 associated with default losses.

6 Modeling non-default losses is going to be an
7 extremely challenging thing and I think it would take
8 probably very non-traditional methods of trying to get
9 to models.

10 So I'm firmly of the belief that we should
11 give the guideline and policy and transparency efforts
12 a shot before we ask for regulation.

13 MS. LEWIS: Thank you, Bis.

14 I want to go to Eric Nield before I go to the
15 MRAC and then Dennis and Teo, I'll come to you guys
16 after we do the round robin with the MRAC.

17 MR. NIELD: I just wanted to be clear that I
18 did not advocate for additional regulations, just to be
19 clear.

20 (Laughter.)

21 MR. NIELD: The additional regulation is
22 difficult because a lot of the focus that we've had in

1 recent years has been the resiliency and the
2 survivability of the clearinghouse, given their
3 systemic concentration of risk, and this issue kind of
4 cuts the other direction a little bit.

5 Chairman Giancarlo, yes, we do have extensive
6 enterprise risk management. We're doing a lot to
7 mitigate these risks, but I don't think that's ever
8 going to eliminate the possibility that there's still
9 going to be non-default losses. So we're still going
10 to have to this discussion.

11 The survivability of the clearinghouse as
12 opposed to who bears the liability of these losses,
13 that's a conflict at times and that's why the
14 regulation is challenging, but the reality is of where
15 we are today and what CCPs have adopted, in Europe,
16 there is a regulation related to investment losses.
17 Guess what. All the clearinghouses have some type of
18 loss allocation system in place in reaction to that
19 regulation.

20 In the absence of something specific, it's a
21 little bit more hit or miss. So I think that kind of
22 answers your question.

1 MS. LEWIS: Tyson Slocum, Public Citizen.

2 MR. SLOCUM: Thank you.

3 I've got two quick questions, if I could. So
4 Mr. Chang laid out, I guess, three categories of non-
5 default losses and Mr. Chatterjee offered a fourth.

6 Just to give me an idea about which ones are
7 driving most of the non-default losses, is there any
8 one of those three or four in particular that is a
9 larger share of those losses or does it really just
10 depend upon the market or whatever?

11 And then second, Mr. Chatterjee, you talked
12 about cyber hacks or other types of cyber breaches
13 resulting in non-default losses. What are the current
14 disclosure requirements by CCPs to report breaches to
15 the Commission, regardless of whether or not they
16 result in non-default losses?

17 Thank you.

18 MS. LEWIS: The Chair recognizes Bis
19 Chatterjee, Citigroup.

20 MR. CHATTERJEE: Thank you, Tyson.

21 I'll take your first question. The scale of
22 losses, that's why I mentioned it, it's really hard to

1 model. If you take something like investment losses,
2 you could have modest investment losses that may be a
3 few cents to a dollar. I understand few cents may be a
4 large number for some people, but, you know, that just
5 is a nature of the loss.

6 Something like cyber, you know, especially if
7 it's, you know, fraud or stealing of funds, could be in
8 larger amounts, but if you compare that to the
9 probability and the number of times it happens, it's
10 probably very few times, you know.

11 So you have events that may happen on a
12 continuous basis. You may lose a few cents on
13 investment but more frequently and that may not really
14 trigger a massive, you know, problem to the CCP
15 ecosystem, but you could have a one-time event in five
16 years where you have a cyber fraud and that could run
17 into hundreds of millions and that could probably shut
18 down the clearing ecosystem.

19 So that is really the challenge with non-
20 default losses is their unexpected nature and how,
21 when, and in what magnitude they occur and how much
22 they are under your control.

1 The other thing I would like to mention about
2 cyber is people immediately focus on funds being
3 stolen. Actually, you know, if you follow the cyber
4 area, there's a lot of malicious attacks that just
5 people are doing for fun to corrupt the system. So
6 they may come in and corrupt margin models. You know,
7 they personally might not gain anything from it, except
8 just take some pleasure in just having an operation go
9 crazy. So cyber is very unusual and therefore again
10 very hard to model.

11 On your second question, I'd rather let my
12 CCP panelists handle it because they probably have a
13 better idea about their interaction with the regulators
14 on that aspect.

15 MS. LEWIS: The Chair recognizes Teo Floor.
16 Are you going to respond to the second part of the
17 question regarding reporting? Okay.

18 MR. FLOOR: I didn't see anyone else put up
19 their tent, so I thought I'll take a stab at it.

20 I think this partly answers the question from
21 Chairman Giancarlo. There aren't major NDL losses, at
22 least not in our CCPs. I mean, these are really minor

1 claims that on occasion occur for operational reasons.
2 So in a very practical sense, the losses, they don't
3 occur. We're talking about very theoretical instances.

4 For the little ones that do occur, those
5 would be in the first bucket. For the ones that I
6 think are the major ones, those would be in the second
7 and then potentially in the third one and the third
8 one, that really depends on the custodial arrangements.

9 In our case, if securities are held in CSDs,
10 then they probably won't be moved out. So it's just a
11 question of time until we have access to them again.

12 It's really the cash investment losses where the size
13 of the market that the CCP clears is much larger than
14 the CCP itself. They're relatively small corporations
15 and in terms of recovery and resolution scenarios, if
16 there was one of the first type that would destroy the
17 CCP and the operator would need to be replaced, then
18 those are relatively small amounts sort of and in terms
19 of financial corporations, we tend to be sort of mid-
20 sized to at best large companies, even for the entire
21 group that typically includes different services, too.

22 MS. LEWIS: The Chair recognizes Eric Nield,

1 ICE Clear Credit.

2 MR. NIELD: And I'll add on to that and I'll
3 give credit to the CFTC since we're sitting in their
4 lovely building.

5 We do have extensive event-specific reporting
6 obligations to the CFTC for system failures, cyber
7 attacks, whatnot, regardless of whether they result in
8 any actual losses, which we don't have -- this is a
9 theoretical discussion. We don't really have non-
10 default losses.

11 So system problems are all reported to the
12 Commission and other regulators and to get back to
13 another related topic about these different types of
14 non-default losses, there's a piece in the IOSCO
15 guidance regarding they're advocating for a first layer
16 loss and investment in custodial losses which we agree
17 with, but they're also advocating that those assets be
18 ring fenced, that they can't be used for any other
19 reason at the clearinghouse, even another non-default
20 loss.

21 This might be my personal opinion. I'm not
22 sure that is the best position. In speaking to our

1 members, speaking to our market participants, when we
2 talk about non-default losses, it tends to be the cyber
3 type of scenarios that they get the most concerned
4 about. This is something that is solely within the
5 responsibility of the clearinghouse and to take assets
6 off the table that are not available for that type of
7 loss may be shortsighted, especially if you're assuming
8 we're in a limited resource world.

9 MS. LEWIS: The Chair recognizes Salman
10 Banaei.

11 MR. BANAEI: Thank you, Alicia.

12 I just wanted to emphasize something that's
13 been just implied in some of the discussions so far.
14 When we think about non-default losses, under that
15 header we have operational risks and we talked in the
16 previous panel about market risk, stress testing.

17 It may be advisable for the industry to also
18 coalesce around new ideas, best practices, for
19 operational stress tests and insofar as we're an
20 authorized non-execution venue trade source for trades
21 that are cleared and settled at a clearinghouse, we
22 would be more than happy to participate in that type of

1 activity.

2 MS. LEWIS: The Chair recognizes Kristen
3 Walters, BlackRock.

4 MS. WALTERS: Thanks, Alicia.

5 So I think Chairman Giancarlo's questions
6 about enterprise risk, I think there's a direct link to
7 just basic accountability. So as an asset manager, you
8 know, BlackRock is paid by clients. We are paid fees
9 to manage assets and corresponding market liquidity and
10 credit risk in a way that's consistent with the
11 client's expectations as outlined in a mandate.

12 As part of that, we are also implicitly and
13 explicitly expected to manage enterprise risk that
14 we're exposed to as part of our investment activities.
15 That includes operational risk, technology risk, cyber,
16 reputational risk to the firm, and third party risk,
17 and third party risk, it's difficult. It's more
18 difficult to manage than direct risk.

19 You know, for us, we need to manage risk, you
20 know, in the real asset space. We hire third parties
21 to manage assets on our behalf. We're essentially
22 responsible for how those assets are managed. We're

1 expected to have proper risk mitigation over third
2 parties. With index providers and, you know, we have
3 over six trillion in assets that are held in custody by
4 third party custodians and we own that risk and we're
5 expected to mitigate risk and, you know, BlackRock's
6 risk management team, of which I'm a part, have spent a
7 lot of time looking at enterprise risk as well as
8 traditional fiduciary risks.

9 So what I would say is on the CCP side, CCPs
10 are paid to mitigate credit risk but you're not limited
11 to mitigating credit risk and, you know, as, you know,
12 my colleague Eileen mentioned, CCPs do generate
13 significant profits and the expectation is that CCPs
14 would also seek to mitigate third party risk in the
15 same way that other, you know, financial firms do in
16 markets, and I think there are a number of established
17 guidelines that are going to bring common sense and,
18 you know, diligence around how to manage these risks
19 appropriately.

20 MS. LEWIS: Demetri Karousos, Nodal.

21 MR. KAROUOS: Thank you, Alicia.

22 Chairman Giancarlo, just a quick answer to

1 your question about additional support of government
2 help.

3 So of course we have risk mitigation
4 practices in place with our ecosystem, but as one of
5 the smaller clearing houses, one of the disadvantages
6 we have is that we don't have access to the central
7 banks.

8 So it would be an advantage for us to reduce
9 something that we consider relatively remote risk of
10 custodial failure to almost eliminate it by having the
11 ability to directly deposit. We are a Subpart C DCO
12 but not systemically important as designated by the Fed
13 and so therefore we don't have access and I know that's
14 not a wand that you can wave. I understand that
15 requires legislative action but that's still with the
16 government. So that's the support we would like.

17 Thank you.

18 MS. LEWIS: All right. Where do I go next?

19 The Chair recognizes Eileen Kiely.

20 MS. KIELY: Thank you.

21 I also wanted to respond to the Chairman's
22 comments about, you know, his rightful surprise that

1 we're all sitting here asking for additional regulation
2 and I think it's important to make this comment for the
3 record that we generally believe that more market
4 forces will drive the right outcome, but we are talking
5 about monopoly operators and market forces don't
6 generally operate as expected when you are talking
7 about monopoly operators.

8 We do not have another option. We can't just
9 choose not to use one of these CCPs around the table.
10 We're mandated to use them. We don't have an option.
11 So I think that's just important for the public record
12 to put that out there.

13 MS. LEWIS: The Chair recognizes Dennis
14 McLaughlin, LCH.

15 MR. McLAUGHLIN: Yes. Again just responding
16 to the Chairman's comments, there are some instances
17 where, of course, we're working as hard as we can on
18 enterprise risk management but there's only so far we
19 can go.

20 So one way, one example of that is that we
21 interact with other PFMIs, whether they be ICSDs or
22 data providers, for example, that can be PFMIs, where

1 we operate at different standards than they do.

2 So, for example, we operate to a Cover 2
3 standard. They might be operating to a Cover 1
4 standard. So it would be good to have some kind of
5 consistent expectation of what is the risk management
6 standard we're working to.

7 The second one is the reporting is very, very
8 inconsistent across, and even you mentioned that,
9 across various institutions in terms of what we
10 actually show, what we actually recognize internally as
11 risk, and right now, for example, in the UK, the Bank
12 of England is starting to lay down what needs to be
13 disclosed in measuring the strength of your control
14 environment, which is actually very, very helpful.

15 So at LCH, we run what we call a materiality
16 matrix which is an objective measurement which can be
17 standardized but it's adapted to a CCP which really
18 measures all the incidents that we've had and, of
19 course, as you know, if you're to follow the
20 operational risk categorization under Basel, basically
21 everything in a CCP will fall in one bucket which is
22 useless. There's no granularity at all. So that might

1 be helpful.

2 And the other way that regulators could be
3 helpful here is, as I mentioned, part of the -- a large
4 part of the investment risk can be avoided if there is
5 access to a deposit account at the relevant central
6 bank and obviously that's not within the CCPs' control.

7 MS. LEWIS: The Chair recognizes Marnie
8 Rosenberg, JP Morgan.

9 MS. ROSENBERG: Thank you, Alicia.

10 I'd just like to reiterate Kristen and
11 Eileen's points of BlackRock, which is, you know, from
12 a JP Morgan perspective, we believe that clearinghouses
13 should be accountable for covering the losses arising
14 from non-default losses since they make the risk
15 management decisions about how to manage the
16 operational risk.

17 There are very few, if any, instances I can
18 think of where clearing members make a decision about
19 how their cash should be necessarily invested. So I
20 wouldn't say clearing members are accountable for those
21 decisions generally.

22 There may be one or two instances somewhere

1 in the world that that is the case, but I think as a
2 general matter that that isn't the case.

3 I would also say that from a capital
4 perspective, defaulting, no pun intended, to the 12
5 months of operating expenses just doesn't seem
6 sufficient to us and doesn't seem necessarily robust
7 enough to cover the potential losses from some of these
8 types of events.

9 Thank you.

10 MS. LEWIS: Are there any questions and
11 comments from members on the phone?

12 (No response.)

13 MS. LEWIS: Isaac, do you have -- oh, I'm
14 sorry.

15 PARTICIPANT: Not from me. Sorry.

16 MS. LEWIS: Thank you.

17 MR. CHANG: So I think this has been
18 certainly a very interesting discussion I think for all
19 of us. I think we're just really -- you know, I think
20 I, too, was initially surprised by the answer to the
21 questions but now that the answers have come back, I
22 think there's some very sensible ideas that at the very

1 least, particularly around funding of last resort in
2 catastrophic situations, that are worth, certainly
3 worth thinking about and exploring.

4 You know, with that, I just wanted to thank
5 each of my panelists for participating today.

6 Thanks.

7 MS. LEWIS: And that concludes Panel Number
8 2. Thank you, panelists. Thank you, Isaac.

9 Panel 3: Central Counterparty Resolution, Leverage
10 Ratio, and Incentives to Clear

11 MS. LEWIS: And now can I ask that the
12 speakers on Panel 3 come forward and take their seats
13 at the panelist table?

14 And now we will have the third panel of the
15 day. As has been mentioned, the central clearing of
16 standardized OTC derivatives is a pillar of the G20
17 Leaders Commitment to Reform OTC Derivatives Markets in
18 response to the financial crisis.

19 Post-crisis reforms include mandatory
20 clearing requirements, capital liquidity and margin
21 requirements relating to OTC derivatives, and reforms
22 relating to resilience, recovery, and resolution of

1 CCPs.

2 These reform measures and the effects of them
3 are the subject of several recent reports, proposed
4 rules, and discussion papers by global standard-setting
5 bodies and credential regulators which the panel will
6 discuss.

7 With that said, I'd like to introduce our
8 panelists for this afternoon's panel.

9 First up, we have Sayee Srinivasan, Deputy
10 Director, Risk Surveillance Branch of the Division of
11 Clearing and Risk.

12 Sayee was the Co-Chair of the Derivatives
13 Assessment Team which produced the FSB CPM IOSCO BCBS
14 Report on Incentives to Centrally Clear OTC
15 Derivatives.

16 Sayee, would you like to start?

17 MR. SRINIVASAN: Thank you, Alicia.

18 I would also like to thank Commissioner
19 Behnam and Alicia for inviting me to present the DAT
20 report at MRAC today.

21 Having spent more than 15 months working on
22 the report, it's good to take a chance to talk about it

1 and publicize it a bit, I guess.

2 I'd also like to thank Chairman Giancarlo for
3 the guidance and support, including tolerating maps
4 from the Chairman's Office, for weeks together at a
5 time.

6 Before that, my remarks are those of my own
7 and not of the Commission or the Commission staff and
8 neither are they comments of the -- represent the views
9 of the Financial Stability Board or members of the DAT.

10 So we called the current report, the 2018 DAT
11 Report as DAT 2.0. DAT 1.0 was published in 2014 at a
12 time when the major portions of the G20 reform efforts
13 were still in advanced stages of design and
14 implementation.

15 Interestingly, DAT 1.0 was made of mostly
16 banking regulators. There was just one market
17 regulator who was part of that report, so.

18 Fortunately, DAT 2.0 had a good mix of
19 banking and market regulators. It was also co-
20 sponsored by BCBS, IOSCO, and CPMI. So a lot of brain
21 damage went into finalizing the report. It was all
22 good work.

1 We were tasked with assessing the interaction
2 of -- the impact of the interaction of capital margin
3 and clearing groups, the key three points of the G20
4 reform efforts, on incentives for firms to clear OTC
5 derivatives.

6 While we start mostly with OTC derivatives,
7 we also made sure we looked at the broader landscape of
8 exchange derivatives.

9 I'll quickly sort of summarize the findings
10 and then talk about some of the process issues,
11 learnings, and next steps.

12 We found that the reform measures
13 incentivized large financial institutions, the ones
14 that transact actively in the global derivatives
15 markets to clear centrally. This is important as these
16 institutions are called the global financial system and
17 key in the sense that they serve as critical
18 transmission mechanisms when there are shocks to the
19 financial system. So to the extent central clearing
20 helps mitigate systemic risk, the reforms are doing a
21 good job. So we got it right.

22 The driving factors are different in terms of

1 the factors that are incentivizing the firms. For
2 large global banks, the banks are incentivized by the
3 margin rules and the capital rules. For non-banks,
4 interestingly, when we say non-banks, asset managers
5 and hedge funds, it's mainly liquidity considerations
6 which are driving incentives to clear.

7 Central clearing helps aggregate liquidity
8 and sort of lowers transaction costs, so if they are
9 trading actively in the marketplace are key
10 considerations.

11 But the reform measures are less effective
12 for firms, whether big or small, who are less active in
13 the derivatives markets. If they're less active then
14 liquidity considerations are literally less important,
15 rather you're more liable finding a clearing member who
16 will accept your business and help clear your trades.

17 Once again, we also looked at not just the
18 client side, we also looked at the clearing firms and,
19 as has been discussed a bit at MRAC forums, clearing
20 firms in the OTC derivatives space are all affiliated
21 with large global banks and what we found is that
22 they're disincentivized both by capital rules and other

1 non-regulatory factors.

2 When we talk about non-regulated factors,
3 there's more work to be done and I'll talk about in a
4 little bit, but what we are really finding is there
5 were high fixed costs with offering clearing service,
6 client-clearing services.

7 So in a nutshell, firms who are on the core
8 of the system, incentivized to clear, firms who are on
9 the periphery of the global financial system, are less
10 incentivized to have reforms to clear centrally.

11 A few words on the methodology and the
12 process. Conducting the impact analysis on large-scale
13 reform efforts is very, very difficult to do. There
14 are no text book models that you can follow. FSB has
15 come up with a framework to do the impact analysis but
16 it's still a work in progress.

17 We relied on a range of different inputs. We
18 did qualitative surveys, quantitative surveys. We took
19 fair amount of technical assistance from market
20 participants, many of them in this room, to help us
21 design the questionnaires.

22 We also had interaction with the market

1 participants, both in U.S. and Europe, as well as in
2 Asia, as we were designing -- coming up with the
3 methodology. We published a draft consultation and got
4 some good feedback and, most important, and I always
5 say we have a lot of data but they're dumb data. We
6 really need the feedback from market participants to
7 understand how to interpret the data. So it was --
8 really appreciate the support we got from market
9 participants.

10 We also relied extensively on regulated data
11 because, of course, the focus of the reforms was also
12 to get regulatory reporting to the various authorities
13 and in the report, we talk about some of the challenges
14 with using the data. There's some more work to be
15 done.

16 In terms of process and also sort of
17 learnings that we have tried to capture in the report
18 itself, as I said, we had -- the DAT was made up of
19 staff from both market regulators and banking
20 regulators.

21 I spent a fair amount of time here at CFTC
22 working on implementing the Dodd-Frank reform rules, so

1 very invested in it, not really educated about capture
2 rules, and there were a bunch of banking regulators who
3 had spent a lot of time working on supplemental
4 leverage ratio and Basel III rules. So we collectively
5 learned a lot about both the macro fiduciary rules as
6 well as the micro fiduciary rules.

7 A huge amount of learning about -- I've been
8 in the derivative business for awhile now and I still
9 managed to learn a lot about the client clearing
10 business.

11 One of the things we discovered was that as
12 an economist, you believe that there's always a market
13 clearing price to clear a product, but for client
14 clearing, there isn't a market clearing price. We
15 wanted to go and ask the firms can you tell us as part
16 of the survey how much do you actually charge to clear
17 a standard 10-year interest rate swap and a fixed float
18 rate interest rate swap. The firm said please don't
19 ask us that question. We can't give that to you.

20 So after doing all this work, I still don't
21 know how much it actually costs for a client to clear a
22 swap, but what we focused on instead was what it the

1 sort of all-in costs for clearing a swap.

2 Just from the CFTC perspective and the staff
3 perspective, as I said, we spent a lot of time
4 understanding the derivatives markets and the client
5 clearing business.

6 We also learned a lot about the leverage
7 ratio, about SIM and SACR, ARUMBA. A comment from Dale
8 Michaels a couple of years ago, about a year ago, where
9 there was a comment that -- just that MRAC was meeting.
10 FCM had let some market declines go. So we've done
11 some interesting work here which is available in the
12 public domain on SAM and the impacting and the exchange
13 derivatives markets.

14 We also leveraged the data that we have to
15 understand SACR and aspects of what I call the
16 miscalibration of SACR which could have unintended
17 consequences in terms of impact on the markets.

18 There's extensive debate within the DAT in
19 terms of the tradeoff between financial stability or
20 what I call institutional solvency and market
21 functioning and we tried to bring some of that debate
22 and concentration into the report.

1 We also spent a lot of time talking about
2 what I was hinting at earlier, the interaction between
3 regulatory and non-regulatory factors.

4 So there's this question that we kept asking
5 which is, what will happen if -- hopefully it's not a
6 hypothetical question and this goes to the point that
7 Commission Berkovitz raised earlier today, was the fact
8 that there's concentration of clearing among a handful
9 of clearing firms.

10 So even if all the capital rules are -- the
11 inefficiencies and the miscalibration is fixed, will we
12 see the concentration go away? Will this be sufficient
13 to incentivize more firms and banks to enter into
14 clearing? I can speculate, but there's some
15 interesting -- some more work to be done.

16 In terms of next steps, the DAT's mandate was
17 very clear. We were not asked to make any policy
18 recommendations. So we sort of drew the line there and
19 we were really careful in not asking the standard-
20 setting bodies to do certain things.

21 Instead, what we did was we highlighted
22 various areas where we thought that the standards and

1 the rules were not -- they were not robust enough and
2 asked very leading questions that an intelligent person
3 can sort of look at them and figure out, well, this is
4 an area where we need to do some more work.

5 The Basel Committee had an area where they
6 looking at impact of the leverage ratio on client
7 clearing. There was a fair amount of coordination that
8 happened with them. They published a consultation and
9 the hope is that the market participants would sort of
10 help them push further on that effort.

11 IOSCO and CPMI and the other standards which
12 are embodied, my presumption is that they're looking at
13 our findings and we shall all be sort of waiting to see
14 where they land in terms of work and analysis.

15 So I'll pause here and if folks have
16 questions, happy to take them.

17 MS. LEWIS: Thank you, Sayee.

18 And now we'll have Marcus -- why did I just
19 forget your name? I know. Marcus Stanley, Americans
20 for Financial Reform, Policy Director, and he'll bring
21 us the public interest perspective.

22 DR. STANLEY: Thank you very much, Alicia.

1 I'd like to thank Commissioner Behnam,
2 Chairman Giancarlo, for permitting me to participate
3 today, and also for your great work, Commissioner
4 Behnam, and Alicia, on putting this event together and
5 doing a really great job on managing the MRAC.

6 As Alicia said, I'm the Policy Director for
7 Americans for Financial Reform. We are a coalition of
8 several hundred organizations working for a stronger
9 and more effective financial regulatory system.

10 So as Alicia said, I do bring a public
11 interest perspective to reading these rules and I'm not
12 going to focus on summarizing the details of the rules
13 but just kind of offer some responses.

14 We have a lot of papers that this panel is
15 nominally reviewing, but at bottom, all these diverse
16 papers address one issue, which is the backstop
17 resources available in the cleared derivatives
18 ecosystem.

19 Higher levels of backstop resources will
20 reduce systemic risk but they also increase the total
21 cost of cleared derivatives to market participants.

22 Prior to the 2008 crisis, resources backing

1 derivatives were far too low. Starting in 2001,
2 notional swap volumes grew five-fold in just six years,
3 an annual growth rate of 32 percent. As markets came
4 under stress, these notional volumes were reflected in
5 a massive growth of actual credit exposure. Three
6 trillion in new credit exposure appeared on the books
7 just over 2007 and 2008. The resources were simply not
8 there to handle that derivatives exposure.

9 It seems clear that swaps received an
10 implicit safety net subsidy before the crisis. It's
11 therefore appropriate that post-crisis regulation
12 increased the private sector resources backing swaps
13 and thus their overall cost.

14 This both makes the system safer and
15 incentivizes a more economically-efficient level of
16 derivatives transactions.

17 Of course, mandatory clearing is a key tool
18 in doing that, but clearing is not an end in itself.
19 It's a means to reduce risk. An under-resourced
20 clearing system will simply be a concentrated node of
21 systemic risk.

22 With that as a background, let me offer some

1 specific comments on these proposals. Multiple
2 proposals address capital held against cleared
3 derivatives by clearing members. It will always be
4 possible to question risk metrics at the position level
5 and we could get into a very technical debate about the
6 SACRE calibration and the CM and so forth, but I don't
7 think that this position level discussion can or should
8 be separated from the general question of clearing
9 member solvency.

10 Clearing member solvency is critical to the
11 issue of CCP resiliency. Under current rules, clearing
12 members must hold capital against individual positions
13 and also some capital against their share of the
14 default fund, but other mutualized risks or exposures
15 beyond the default fund are not capitalized, including
16 potential upward adjustments of the default fund in
17 stressed markets, capital assessments beyond the
18 default fund, and, perhaps most importantly, the
19 potential need to assume positions from a defaulted
20 member in an auction.

21 Everything about these potential events
22 becomes easier, less risky, and more reliable when

1 members are better capitalized.

2 The paper on incentives to clear also raises
3 the issue of clearing member concentration and its
4 relationship to the cost of clearing, including
5 capital. Excessive concentration of clearing services
6 can also contribute to systemic risk, but we should be
7 seeking ways to increase the number and diversity of
8 FCMs offering client clearing without increasing the
9 overall leverage in the system.

10 Given the dominance and significance of a
11 small number of large bank FCMs, we should especially
12 not be taking test steps that could reduce the
13 capitalization of these institutions. Instead, we
14 should be ensuring that they're as strong and solvent
15 as possible.

16 One way to do this might be by targeting
17 capital requirements that do not affect smaller
18 institutions in the same way, such as, for example, the
19 G-SIB surcharge and its relationship to clearing
20 volumes.

21 To move on to the paper on clearinghouse
22 resolution, this paper was full of tactical details,

1 but I wish today to take a more strategic approach to
2 examining possible contradictions within the three
3 stated goals of CCP resolution and I'm talking about
4 the goals of CCP resolution in the BIS resolution
5 guidance.

6 Those goals are maintaining CCP function,
7 protecting taxpayers, and maintaining financial
8 stability.

9 In a situation where CCP recovery efforts
10 have failed, probably failed multiple times, with the
11 resulting loss of market confidence in the CCP, these
12 objectives may come into conflict and raise difficult
13 questions for regulators. It would be beneficial to
14 make answers to those questions clear in advance.

15 Reading between the lines, the resolution
16 paper also implies that it will be challenging to
17 actually use CCP equity to absorb losses in a highly-
18 stressed resolution-type situation. For one thing, we
19 can expect that CCP equity won't be highly valued in
20 the market in that situation.

21 There would therefore be significant
22 advantages to pre-funding such skin in the game through

1 retained earnings during good times when CCP valuations
2 are high and not to pick on CME but I just took a look
3 at CME with a market capitalization of 65 billion
4 appears to pay about 80 to 90 percent of its operating
5 income out to shareholders. That's about two billion a
6 year.

7 CME's default fund currently stands at 8.3
8 billion. Over multiple years, it seems that retained
9 earnings could make a meaningful contribution to the
10 default fund while still permitting strong levels of
11 dividends as a fraction of operating income.

12 My final thought is not directly addressed in
13 the papers we're reviewing but it seems to me critical
14 in all of them and that's regulatory stress testing.

15 Initial margin will always be the most
16 important element of loss absorption in a true systemic
17 risk situation. If cleared margin is set in a truly
18 robust and counter-cyclical manner, many other
19 questions will be much less pressing.

20 It did concern me that we heard prominent
21 clearing members in this morning's panel and our last
22 meeting raise some questions about CCP margin model

1 calibration.

2 Regulatory stress testing should be a key
3 mechanism for ensuring that we get margin right. As we
4 all know, the CFTC is under-resourced and within those
5 resource limitations, staff have been doing a great job
6 standing up the operational capacity to stress test
7 CCPs.

8 Now that we have that capacity and several
9 years of experience in running stress tests, we should
10 think about how to use these tests to explore a greater
11 and more challenging range of stress scenarios.

12 CFTC tests so far have found adequate
13 resources, but there's a growing outside academic
14 literature that raises concerns about issues ranging
15 from a breakdown in correlation assumptions to network
16 effects on losses.

17 The CFTC should work to incorporate these
18 concerns in future stress tests and should also engage
19 with clearing members to ensure that member concerns
20 about margin models are addressed.

21 And as one final note on stress testing, the
22 FSB paper on CCP resolution calls for identifying

1 potential loss scenarios in advance that may lead to
2 resolution and this seems to me to suggest a potential
3 role for reverse stress testing to try to identify
4 those scenarios.

5 Thanks very much.

6 MS. LEWIS: Thank you, Marcus. Apologies.

7 And now we'll have Robert Wasserman, Chief
8 Counsel, Division of Clearing and Risk, and he'll talk
9 about the BCBS Consultative Document as well as the
10 Prudential Rules as well as the FSB Adequate Resources
11 in Resolution and Treatment of CCP Equity in
12 Resolution.

13 MR. WASSERMAN: Thank you.

14 So I'd like, as well, to thank Commissioner
15 Behnam and Alicia for inviting me to be here. Also
16 need to give my usual disclaimer which is to say that
17 the views I express are not necessarily those of the
18 Commission nor of the staff or even of myself if I'm
19 directed to change them by competent authority.

20 So I think I'm going to start with the FSB
21 paper and I think it's important to have some
22 historical context. So last July, in 2017, the FSB

1 issued final guidance on CCP resolution and resolution
2 planning and that guidance covered topics, including
3 objectives of CCP resolution and resolution planning,
4 resolution authority and powers, resolvability and
5 resolvability assessments, standards for entry into
6 resolution, the concept of no creditor worse off, and
7 so in fairness, the guidance that I'm going to talk
8 about that this year is basically covering a number of
9 topics that were not addressed but then essentially
10 much of the scope was really taken care of back in
11 2017.

12 The two topics that are being addressed
13 currently are, as has been noted, financial resources
14 to support CCP resolution and treatment of CCP equity
15 and resolution, and the paper was issued on November
16 15th. Comments are due by February 1st, and, indeed,
17 as well, there's going to be an industry forum in Basel
18 in January -- excuse me -- in Madrid, rather, in
19 January.

20 Now the paper covers financial resources
21 through a five-step analytical process and it's pretty
22 logical in the sense that it's looking at identifying

1 hypothetical default and non-default resolution
2 scenarios and I should note this is not going to be
3 specific to, well, what happens if this happens to the
4 oil market or if some other market. It's, rather,
5 looking at, well, given especially the standards that
6 are already there in PFMI, how might we actually get
7 into resolution, given the availability of recovery
8 tools?

9 Then you need to evaluate the existing tools
10 and resources and these include, with apologies,
11 assessments, gains-based haircutting, partial tear up
12 and other powers of resolution authority, and, of
13 course, in the case of non-default losses, which were
14 discussed in the last panel, these include things like
15 the CCP equity, insurance, and in some cases allocation
16 pursuant to a CCP rule.

17 Next step. You've got to look at the full
18 resolution costs and that includes obviously both
19 essentially the sort of operational but, as well, the
20 substantive costs, and then the next logical step is to
21 compare the tools and resources to the costs and
22 identify the gaps.

1 Finally, consider the availability, costs,
2 and benefits of potential means of addressing those
3 gaps and so that's sort of the analytical process that
4 is described in the paper and so again there's comments
5 on that.

6 As well, there's the questions of treatment
7 of equity. The guidance focuses on potential
8 mechanisms for adjusting treatment of CCP equity and
9 resolution, but it also recognizes that there's some
10 very important challenges and constraints.

11 One of the most important of those is no
12 creditor worse off and so, in other words, to the
13 extent that equity is not subject to loss in an
14 insolvency because of the CCP rules, which are the
15 contract between CCP and its members, then you would
16 have problems both under the international standards
17 and, frankly, as well, under U.S. law, Dodd-Frank, if
18 you were to assign losses to the equity holders that
19 they would not be subject to in the alternative
20 counter-factual of insolvency.

21 And another challenge, as well, which again
22 we have here in the U.S., is the extent to which there

1 may be a lack of authority under the statute in this to
2 impose those losses.

3 As well, the paper asks folks to consider
4 policy issues, including the incentives of CCP
5 management to pursue sound risk management and the
6 incentives of clearing members to support recovery.

7 Also important to consider the historical
8 context of the leverage ratio issues and so I should
9 note that back in 2012, gosh, it feels like ancient
10 history now, the Basel Committee realized that
11 exposures to CCPs carried risks and that those risks
12 needed to be assigned a risk weight.

13 They first implemented an interim approach to
14 recognizing those risks and then convened a joint
15 working group with participation from BCBS, CPMI or
16 actually its predecessor, and IOSCO, and I actually co-
17 chaired that group on behalf of CPMI and IOSCO.

18 In 2014, that joint working group completed
19 its work and the BCBS promulgated risk-based capital
20 charges for bank exposures to CCPs and those charges
21 include trade exposures as well as default funds and
22 include consideration of -- you know, as part of that

1 process, included consideration of assessments. These
2 have been implemented and so far as I know, no one is
3 pushing to change them.

4 However, BCBS has more recently promulgated
5 capital charges based on the leverage ratio. This is
6 by intent and design a non-risk-based backstop to risk-
7 based capital charges and calculations for the leverage
8 ratio, again by tradition and design, do not include
9 recognition of collateral. So, indeed, the most
10 important and effective risk mitigant that we have
11 liquid collateral in the hands of the CCP and the
12 clearing member, no recognition at all, and that,
13 indeed, has been the problem.

14 And they're ignoring this liquid collateral
15 that the CCP rules require FCMS to collect and that
16 Commission regulations require them to segregate.

17 This has had, unsurprisingly, a negative
18 effect on banks, FCM's willingness to take on or
19 continue customer business, and a lot of those problems
20 have been discussed by Commissioner Berkovitz earlier
21 as well as by Sayee and his group.

22 The problem is unlike bank broker-dealer

1 rather than FCM capital requirements, which focus on
2 the legal entity, bank capital requirements are
3 calculated at the holding company level and the actual
4 impact of the leverage ratio at the holding company
5 level is actually fairly small but at the business unit
6 level, it can be much larger indeed, and with all due
7 credit to my friends and colleagues at the Basel
8 Committee, their incentives work.

9 Banks and bank holding companies, including
10 FCMs, take into account the leverage ratio when they
11 apply it at the business unit level and that
12 application at the business unit level is what causes a
13 lot of the problems.

14 Thanks, I think, in part to both sort of a
15 drumbeat that's been continuing for a number of years
16 and especially, as well, the good work that Sayee and
17 his colleagues did, there have been what I have been
18 referring to as recent green shoots of hope, both at
19 the Basel Committee level, a targeted consultative
20 document, and among the U.S. credential regulators.

21 And so Basel issued a consultation in October
22 for comment by January 16th. They are considering "a

1 targeted and limited revisionable leverage ratio
2 exposure measure with regard to the treatment of client
3 cleared derivatives only," and I will says I think part
4 of their concern is given their reluctance to recognize
5 collateral, I think they really need to be assured that
6 this exception is not going to in fact be a breach in
7 the wall that knocks the wall down.

8 They warn that absent a strong evidence-based
9 case to revise the treatment, the committee will retain
10 the existing treatment and so it is definitely not time
11 to begin celebration yet. There's work to be done.

12 They are considering recognizing collateral
13 consistent with SACR, the Standardized Approach to
14 Credit Risk, which is to say allowing an offset that
15 asymptotes at leaving five percent of the exposure
16 remaining and that is again consistent with the risk-
17 based approach.

18 They have inquired into how to impose
19 segregation criteria so as to ensure that initial
20 margin "will be available in the event of a client's
21 default. Those criteria could specify limitations on
22 the committee uses by clearing member banks of initial

1 progress has been made in that essentially the door is
2 at least partially open and for those of us who look at
3 things from a legal perspective, asking a question in a
4 proposal means that answers to that question could be
5 part of a logical outgrowth of that proposal, but I
6 think it's very important and I urge industry folks to
7 think very carefully about how they react to these.

8 You guys, the industry folks are obviously
9 the best judges of their own interests in doing this.

10 That said, as someone who has a professional
11 interest in appropriate capital treatment for exposures
12 to CCP and again looking at the important impact on the
13 availability of clearing and the resilience of the
14 clearing ecosystem, I would urge folks to treat these
15 opportunities as an opportunity to be nurtured.

16 You might well benefit by submitting
17 responses that demonstrate a willingness to engage on
18 the concerns that the Basel folks and the prudential
19 regulators have raised, such as segregation criteria
20 and why they're effective, and the very limited scope
21 of impact on holding company level leverage
22 requirements.

1 I think you should also carefully endeavor to
2 demonstrate the impact of the leverage ratio on the
3 costs and availability of client clearing and I know
4 from Sayee's experience that that can be very difficult
5 but again this is what they're calling for and this is,
6 I think, what the opportunity is.

7 I'd like to just take a brief moment to react
8 to some of the concerns raised earlier that have
9 relation to some of this.

10 I very much agree with the concerns folks
11 have raised concerning effective and well-designed
12 margin models. I would note that both the
13 international standards and our regulations impose
14 discipline on this process through back testing
15 requirements and I would also note that our regulations
16 impose margin-based and thus risk-based capital
17 requirements on FCMs.

18 That said, you know, there are a number of
19 exposures, including in recovery, but at least for the
20 past couple of years, I am not aware of anyone who's
21 focusing on forced allocation and so having clearing
22 members being forced to take on positions is something

1 that I think may not be as much of an issue now, albeit
2 partial tear-up has some very difficult effects on
3 folks who that might be visited upon.

4 I also agree that stress testing is a
5 critical part of risk management. Part of that is
6 supervisory stress testing and my colleagues, including
7 Sayee and his group, have done and are doing some very
8 important and good work in that area.

9 Of course, those cross CCP stress tests can,
10 as a practical matter, only cover a limited scope of
11 scenarios. Stress testing at the DCO level should
12 cover a broader scope of scenarios appropriate in each
13 case to the business of that DCO.

14 I will quote from the guidance issued last
15 summer by CPMI and IOSCO in this regard, that a CCP
16 should complement stress scenarios based on historical
17 data with stress tests based on a full spectrum of
18 forward-looking scenarios.

19 These scenarios should aim to capture stress
20 events that are plausible but have not occurred
21 previously and development of forward-looking scenarios
22 should be informed by the judgment of subject matter

1 experts from within the CCP or the participant
2 community and these experts should have knowledge of
3 the underlying markets, including the relevant
4 economic, physical, environmental, or geopolitical
5 factors.

6 In short, a simple statistical approach, I
7 think, is not enough. If you're going to be developing
8 scenarios, you've got to involve folks who understand
9 the markets.

10 Last month, we celebrated the Centennial of
11 the end of World War I and that reminds me of the
12 Maginot Line which was built by the French based on the
13 lessons learned from that war. It was impervious to
14 most forms of attack. In World War II, the Germans
15 simply went around that line through Belgium. Basing
16 your defenses only on the ability to fight the last war
17 just doesn't end well.

18 Thank you.

19 MS. LEWIS: Thank you, Bob.

20 And now I would like to open it up to the
21 MRAC for questions. I'm sorry.

22 Jim Shanahan, CoBank.

1 MR. SHANAHAN: Thanks, and I really
2 appreciate you guys looking at this.

3 I wanted to relate to you guys, you know, the
4 consolidation in the FCM market as end users and I'll
5 give you a little feedback on costs, too, that the Farm
6 Credit Banks, as we've looked to add FCMs and give back
7 to FCMs, is becoming really increasingly difficult to
8 negotiate agreements that we feel meet the criteria
9 that we have and we've actually worked -- begun really
10 working together to try and use our market power to
11 kind of put those kind of agreements in.

12 It's also really tough when you have long-
13 term one-way exposure on your books to get much limit,
14 especially if you're looking at possibly porting any
15 transactions or even going to another CCP, and I will
16 tell you also and related to costs, you can negotiate
17 an agreement and then have somebody come back a couple
18 months later with a significant cost increase or
19 minimum fees which, you know, you have to deal with
20 and, you know, as the Farm Credit Banks, we have some
21 ways to deal with that, ask them if they ever want to
22 underwrite debt again or something like that, and we've

1 been able to work around that.

2 But some of our members who have, you know,
3 tried to explore avenues of clearing, based on a more
4 voluntary -- on a cost basis, have really hit a
5 stonewall and some of the aspects where they come into
6 a transaction that is a legitimate hedge that they need
7 to put on the books, there's significant impediments to
8 being able to operate in cleared space and it's just
9 something I know that the Commission is concerned
10 about. They've expressed that, but it's actually, you
11 know, a couple years ago, there were a lot of articles.
12 There hasn't been much written about it lately, but
13 it's actually probably even worse now than it was a
14 couple years ago.

15 So I just wanted to throw that out as a
16 representation.

17 MS. LEWIS: Thank you, Jim.

18 Boog Zubaride, Chatham Financial.

19 MR. ZUBARIDE: Thanks, Alicia.

20 And Chatham would echo your comments, Jim.

21 Certainly we have financial end user clients who depend
22 on these markets to hedge risk who face challenges

1 associated with the costs of clearing and, you know,
2 appreciated the DAT's questions and the consultation
3 with respect to the impediments to clearing for
4 financial end users.

5 National regulators in various jurisdictions
6 have made accommodations for financial end users, non-
7 financial end users, with respect to in some cases
8 clearing, in some cases margin, and in some cases the
9 CVA capital charge, particularly for entities that are
10 outside of what the report referred to as the systemic
11 core of the market.

12 So, for example, non-financial end users
13 globally have been exempted from clearing in margin
14 requirements. In the U.S., we have small banks who are
15 exempt from those requirements. Many in various
16 jurisdictions, financial end users that transact below
17 certain notional thresholds have been exempted, and in
18 Europe, non-financial end user hedges are exempted from
19 the CVA capital requirement applicable to banks.

20 I didn't see in the report criticism by the
21 regulators with respect to these types of
22 accommodations and I'm wondering if it's reasonable to

1 infer that the DAT does not view these accommodations
2 as inconsistent with the financial stability objectives
3 of the G20.

4 MS. LEWIS: Sayee, would you like to respond
5 to that?

6 MR. SRINIVASAN: No. We are completely in
7 agreement. I think we tried to raise these issues,
8 which is why we tried to frame it in the context of the
9 core and the periphery, and we did get into the weeds
10 of CVA.

11 We would like to do more than just that. It
12 wasn't sort of CVA. There are a few people who don't
13 understand CVA. A lot of us I don't claim to
14 understand much of it, but we did sort of raise these
15 issues. That is, once again, there is this tension
16 between one of the questions that comes up -- there are
17 a lot of small firms collectively if you exempt them
18 from the requirements, will that cause this sort of
19 systemic risk?

20 My further argument would be we have great
21 data today. All these data are reported. They're
22 doing swaps. If an end user does a trade, the

1 regulatory reporting that happens. So we ought to be
2 able to sort of do the analysis and do it.

3 So it was end user issues was critical to us
4 and we tried to highlight it, but one of the challenges
5 with doing these surveys is that end users and smaller
6 firms are not well-oiled machines in terms of providing
7 us feedback that's important for it, but I think I like
8 to believe it's sort of a decent job of highlighting
9 these issues and there's more work to be done in terms
10 of working with the standard-setting bodies and others.

11 I think what you've done is provided the fact
12 that the DAT with the sort of mixed group that we had.
13 We laid out these things in a systematic manner.
14 Actually, we're opening doors for other participants
15 and others to provide more data and arguments to make
16 the case to the standard-setting bodies and others to
17 start reconsidering the standards.

18 MS. LEWIS: Thank you, Sayee.

19 The Chair recognizes Dennis McLaughlin, LCH.

20 MR. McLAUGHLIN: Thank you.

21 I have a question for Bob. You said a lot of
22 things, but one of the things you were talking about

1 was no creditor worse off.

2 So given that the CCP rulebooks, as they are,
3 they will allocate losses to the last drop from a
4 member default and the only way they can be overridden
5 really is if there's systemic reasons to override the
6 rulebook from a resolution authority. So, in other
7 words, the greater good can trump.

8 Now my question is, if you look at no
9 creditor worse off, is there any circumstances where
10 that can be trumped by the greater good or is it always
11 an inviolate principle?

12 MR. WASSERMAN: So I obviously don't practice
13 law in the U.K. So I can't speak to the insolvency law
14 that would be applicable, you know, in LCH's case.

15 I think the point of no creditor worse off is
16 that essentially -- and that concept is, by the way,
17 baked into, for instance, Dodd-Frank as well as the
18 international standards -- is that if you're going to
19 do something for the greater good, you should not be
20 doing that at the expense of particular creditors and
21 so the comparison is to, well, if instead of taking the
22 entity through resolution, you took it through

1 insolvency, how would things end up?

2 Now my experience in the sort of the
3 bankruptcy context is that arguments as to what people
4 would suffer in the event of insolvency can be very
5 theoretical and there's all sorts of ways to argue
6 things, but I think the point is that, you know, you're
7 comparing it to that counterfactual rather than saying,
8 hey, the greater good compels it, so whoever happens to
9 lose under the greater good, how sad, too bad.

10 The idea is that no, folks who -- you know,
11 the resolution authority can do those things, but then
12 folks who lose compared to where they would be in
13 insolvency then have claims.

14 MS. LEWIS: The Chair recognizes Bis
15 Chatterjee, Citigroup.

16 MR. CHATTERJEE: Thank you, Alicia.

17 Sayee, if I could turn to you and go back to
18 the survey, you know, I think the survey did a great
19 job. I think it was, you know, while the responses may
20 not have covered the breadth of the participants, it
21 definitely was one of the few quantitative surveys
22 we've seen.

1 You know, going back to the issue in there on
2 incentives to clear, obviously, you know, market
3 participants provided a lot of inputs into the
4 different incentives, you know, counterparty netting
5 principle, capital efficiency.

6 Were you surprised by the order in which the
7 incentives, you know, showed up? You know, a lot was
8 made about the disincentive of the mandatory margin on
9 non-cleared products and why that's pushing, you know,
10 products into clearing, but it doesn't seem to have
11 appeared very prominently high on, you know, the
12 rankings.

13 Secondly, you know, if that is truly an
14 incentive in pushing more products into clearing, at
15 what point does that become a systemic risk issue
16 because you're putting non-cleared/non-liquid products
17 into the clearinghouse?

18 MR. SRINIVASAN: So there was in terms of the
19 radius responses, right, there wasn't anything that's
20 sort of really surprising, at least on sort of the list
21 of things that you just mentioned.

22 What was very interesting was that we relied

1 on different sources. So to date, what at least I've
2 seen as radius in a forum like MRAC and FIA and other
3 conferences, industry just coming and constantly
4 complaining and this was the first effort by the
5 official sector to systematically study it and, as you
6 said, you know, there's academic research, there's
7 regulatory data, there is qualitative surveys, and
8 there's the pricing survey, what you call the
9 quantitative survey, and the inputs from all these
10 different sources responding in the right direction,
11 which I think was the most important thing, I guess,
12 which gives you the sort of solid foundation, saying
13 are we not being assured that the industry is not just
14 lobbying exercise but here when you look at evidence
15 coming from so many different places, it's a
16 confirmation that that is an issue here.

17 And the other challenge I think we've had,
18 this is just my interpretation of the approach to
19 rulemaking and others, is, you know, this was all done
20 to sort of reduce financial stability but then it was a
21 very like a one-size-fits-all approach and I think what
22 we have done is the rulebook shows us that mandatory

1 clearing is important to reduce systemic risk.

2 At the margin, it's coming at a very high
3 cost and, you know, we asked some very leading
4 questions on. Somebody has to go and do the analysis.
5 It was we didn't have the bandwidth to do that. You
6 know, if you were to sort of give relief to the other
7 firms, the smaller firms, will that actually reduce,
8 you know, any sort of gain from systemic risk?

9 The challenge that I think -- this is where
10 it comes to the trade-off between financial stability
11 and systemic risk. The concern that I personally have
12 is the issue of the concentration that's happening and
13 we label a lot of these things where we see firms,
14 clearing members and this is based on the responses
15 from clearing members where, you know, the pricing
16 model keeps changing and the clearing members are
17 actively, what you call, optimizing the client
18 relationship, meaning you will have firms and clients
19 who lose access to the cleared markets and if that
20 causes them to stop hedging their risk because one of
21 the key findings from the study is that there's been a
22 bifurcation of liquidity within cleared and uncleared

1 markets.

2 Liquidity concentration improved in the
3 cleared markets and likely deteriorated in the
4 uncleared markets. It's hard to do the analysis but
5 that's what we find. So we are kicking people out
6 because they don't have access to clearing from the
7 cleared markets and where do they go because liquidity
8 is deteriorated in the uncleared market and they choose
9 to not hedge the risk.

10 These are things which one would love to
11 measure but can't be measured and which is where I
12 think from a policy perspective we should be focusing
13 on, right, things which can't be measured, but it's
14 likely happening then and we should be mindful of the
15 unintended consequences of our reforms.

16 It's a very long-winded answer to your
17 question but that's some take-aways, I guess.

18 MS. LEWIS: Thank you, Sayee.

19 The Chair recognizes Stephen Berger, Citadel.

20 Mr. Berger: Thank you.

21 I just want to make a few observations in
22 reaction to some of the comments and discussion that's

1 just happened.

2 First off, I think there was a discussion of
3 the systemic core and the periphery and I guess my view
4 on that is that, you know, you have a network of
5 bilateral or counterparty credit exposures, the nodes
6 of which are a handful of, you know, dealer banks, each
7 of which has, let's say, you know, a thousand
8 uncleared, you know, bilateral relationships.

9 So something is achieved if you apply
10 requirements just to transactions among the largest
11 dealer banks but when one of them fails, the risk
12 propagates through the thousands of, you know,
13 bilateral counterparty risks that they have.

14 So even though each individual end user in
15 isolation obviously presents no systemic risk, you
16 still need to consider the market structure and whether
17 we reformed it in whole or left parts of it as sources
18 of systemic risk.

19 So that brings us to kind of looking at,
20 okay, so how far in that dealer-to-customer portion of
21 the market, what have we, you know, achieved to date?
22 We've achieved a lot. In the United States, we've

1 achieved, frankly, more than in any other jurisdiction
2 that we can look at in terms of implementing the G20
3 reforms, but when we look and, you know, a lot of
4 praise and respect for the work that was done globally,
5 but I think we also have to be cognizant of the fact
6 that if we look in the dealer-to-customer market
7 outside of the United States, there really hasn't been
8 a full implementation of the clearing obligation.

9 Europe is the only jurisdiction that's really
10 made significant progress but still over 90 percent of
11 financial counterparties in the EU are still out of the
12 scope of the clearing obligation and the next phase is
13 supposed to be implemented in June of 2019.

14 But you go beyond Europe, there's, you know,
15 clearing obligations that really have just been limited
16 to the inter-dealer market and, you know, the global
17 implementation schedule for uncleared margin
18 requirements hasn't hit anybody on the buy side and it
19 won't until 2019 and 2020, with the exception of one
20 firm.

21 So, you know, the stock-taking exercise, I
22 think, still -- there's still a few years of

1 implementation to play out before you really completely
2 understand that.

3 On the kind of uncleared initial margin
4 requirements and whether they're designed to
5 appropriately account for the risks that's posed by
6 uncleared swaps versus service to incentivize greater
7 central clearing, I think we do have to appreciate the
8 fact that in the cleared ecosystem, there's, you know,
9 exchange of variation margin and, fortunately, now in
10 the uncleared ecosystem, there's daily exchange
11 variation margin.

12 In the cleared ecosystem, all margin
13 participants on both sides of the trade, close initial
14 margin, and in the uncleared ecosystem, we still have,
15 you know, a lot of inconsistency, either neither side
16 posts, one side posts, etcetera.

17 So I think until the uncleared system is
18 brought at least to the same level as the cleared
19 system, it's difficult to kind of argue that there's
20 unduly penalizing the uncleared system, you know. I
21 think it's completely rational to ensure that the
22 margin requirements they do apply to non-centrally

1 cleared swaps are appropriately calibrated, but I still
2 think that same kind of minimum margin discipline with
3 respect to both sides having to post initial margin,
4 it's important to put both sides on the level playing
5 field.

6 And last comment I would make is that there
7 are concerns, and I think, you know, the work that's
8 being done on the leverage ratio is excellent, long
9 overdue, and so I think that should help address access
10 to, you know, clearing capacity for clients who need
11 it.

12 But, you know, in terms of the supply that I
13 think everyone was hoping would exist, part of the
14 reason that it's not there is we've, frankly, taken a
15 really long time to implement what people were
16 developing the capacity to support and so if you were
17 -- I sympathize, I guess, with the FCM that in 2009 was
18 like I better build a client clearing business.
19 There's going to be a lot of client clearing demand in
20 the next year or two and nine years later, there's only
21 one jurisdiction that's really implemented a clearing
22 mandate in the dealer-to-customer market.

1 So I assume after, you know, the two-year
2 check-in and the four-year check-in and the six-year
3 check-in with business management, they were told you
4 canceled our business plans and so I think that's a
5 lesson that says that like delays in exemptions,
6 however well intentioned and however much they're given
7 to sympathetic petitioners, can actually undermine the
8 overall objectives that we're trying to achieve in
9 terms of moving a critical mass of liquidity in the OTC
10 derivatives markets into a more clear, transparent
11 ecosystem.

12 MS. LEWIS: Thank you.

13 Is there anyone on the phone that has any
14 questions or comments?

15 (No response.)

16 MS. LEWIS: Thank you.

17 Marcus Stanley, we'll give you the last word.

18 DR. STANLEY: Oh, I guess I just wanted to
19 say a short thing in response to what Luke was saying.

20 I think that we should remember, in addition
21 to the complexities of the network that we've built up
22 that Stephen Berger just talked about, there's actually

1 a long history of financial crises caused by sort of
2 mass failures in smaller entities, the S&L crisis, the
3 Great Depression, and the difficulty of -- I don't
4 think we should rely on just the data monitoring
5 capacities of the regulatory system as the stand now to
6 tell us whether systemic risk is building up among
7 those networks of smaller entities.

8 There's already quite a number of exemptions
9 in place and I think multiplying them too much could be
10 dangerous.

11 MS. LEWIS: Thank you, Marcus.

12 Well, that concludes Panel 3. Many thanks to
13 our speakers, and at this time, we'll take a five-
14 minute break so we can set up for the next panel.

15 Thank you.

16 (Recess.)

17 MS. LEWIS: Okay. The meeting is called to
18 back to order and now we'll have the last panel of the
19 day, Oversight of Third-Party Service Providers and
20 Vendor Risk Management.

21 Annette Hunter of the Federal Home Loan Bank
22 of Atlanta is the facilitator of this panel.

1 Annette.

2

3 Panel 4: Oversight of Third-Party Service Providers
4 and Vendor Risk Management

5 MS. HUNTER: So thank you. Can you hear me?

6 Good. Because I've heard there's a little bit of
7 trouble with hearing today.

8 So thank you, Alicia, and Commissioner
9 Behnam, for allowing me to facilitate this discussion
10 today on the Oversight of Third-Party Service Providers
11 and Vendor Risk Management.

12 My name is Annette Hunter, and I manage the
13 back office functions for Federal Home Loan Bank of
14 Atlanta.

15 Federal Home Loan Bank of Atlanta is a GSC
16 and we're regulated by the Federal Housing Finance
17 Agency and before I'm going to do a little plug for the
18 Federal Home Loan Banks, we just issued two billion in
19 SOFR debt in November and we're --

20 (Applause.)

21 MS. HUNTER: -- in Atlanta and we are
22 educating our members and the community banks, so just

1 a little plug there.

2 Back to Vendor Risk Management, so we've been
3 included in the discussions with our regulator when
4 forming our risk-based approach to vendor management.
5 So over the last few years, the banks have taken a
6 risk-based approach to vendor management. The focus
7 has been on strategy, inherent risk of selecting a
8 vendor, due diligence, contract negotiations and
9 review, ongoing monitoring, contingency planning, and
10 documenting all of this.

11 It's important for all financial market
12 participants to have this kind of approach or a similar
13 approach. I made the assumption when I was getting
14 ready for this that everybody did and then I kind of
15 learned the hard way that not everybody does.

16 So I'm happy to facilitate this discussion
17 and I look forward to learning how we can improve our
18 processes at the bank.

19 Ultimately, the goal of the conversation is
20 to consider whether the CFTC adequately sets standards
21 and guidance for its registrants to follow when they
22 engage in third party vendors. So I've been asked to

1 frame this challenge.

2 So I'm only going to focus on a couple areas.

3 I'm sure there's many more areas and feel free to jump

4 in with those with your questions or your

5 presentations.

6 So managing the relationship and

7 accountability. So each organization's expected to

8 serve their customer and manage their core business, no

9 matter what the challenge. You know, we were

10 challenged with SOFR. We worked with our vendors to

11 make sure that happened.

12 But what happens when your major service

13 provider has an issue and then your systems go down?

14 Are they accountable? Have you kept your vendor

15 accountable? Have you formed relationships? It takes

16 a lot of resources to form those relationships with

17 your vendors because you want a quick resolution.

18 Should a third party or fourth party vendor

19 be required to provide a business continuity plan? I

20 would like that. So should there be different

21 requirements on critical versus non-critical services?

22 We think there should, but I'm curious of what

1 everybody else thinks.

2 The other area is emerging technologies, like
3 cyber security and block chain and/or not cyber
4 security, cloud, which means cyber security sometimes,
5 cloud and block chain. What are some of the challenges
6 and risks with that? What are the issues with
7 resiliency in the event of a cyber issue?

8 As I said, I'm sure there's many other
9 challenges we can bring up but I'm happy to introduce
10 the panelists now.

11 Lazaro Barreiro, Director of Governance and
12 Operational Risk Policy for the Office of Comptroller
13 of the Currency. Would you like to present?

14 MR. BARREIRO: There's a trick to saying the
15 name. It's Barreiro. Say it really fast.

16 Thank you for the opportunity to address the
17 Commission today.

18 I'd like to address or discuss the OCC's
19 guidance on third-party risk management.

20 Banks continue to increase the number and
21 complexity of relationships with both foreign and
22 domestic third parties, such as outsourcing entire bank

1 functions to third parties, such as tax, legal, audit,
2 information technology, operations, basically the
3 entire back office, outsourcing of lines of business or
4 products, relying on single third party to perform
5 multiple activities to such an extent that the third
6 party becomes an integral component of the bank's
7 operations.

8 Working with third parties that engage
9 directly with customers to the point where the customer
10 doesn't know if they're dealing with the bank or the
11 third party. Contracting with third parties that
12 subcontract activities to other foreign or domestic
13 providers, we don't know who's providing the services
14 at the end of the day.

15 Contracting with geographically-concentrated
16 firms, working with a third party to address
17 deficiencies in bank operations or compliance where the
18 third party is actually providing assurances that the
19 bank is in compliance with laws and regulations.

20 As you can imagine, the number of third party
21 relationships can easily number into the thousands for
22 any one bank. This is a complex process that requires

1 clear management. These third party arrangements, if
2 not done correctly, can impact the safety and soundness
3 of an institution.

4 The OCC came out with Bulletin 2013-29 to
5 address risk management expectations for the banks and
6 provide guidance to the examiners.

7 We also asked examiners and banks to refer to
8 OCC Bulletin 2017-43, New, Modified, or Expanded Bank
9 Products and Services, Risk Management Principles.
10 This can provide the flavor of your coming up with new
11 products or services, some of the things to consider.

12 We expect banks to develop risk management
13 processes commensurate with the level of risk and
14 complexity of its third party relationships. So small
15 institutions obviously don't need to develop great and
16 elaborate process as much as we would expect of the
17 larger institutions that have much more complexity and
18 integral operations with some other third party
19 providers.

20 Banks should ensure comprehensive risk
21 management and oversight of third party relationships
22 involving critical activities, I should say for all

1 third parties, but those that provide critical
2 activities require much more oversight and due
3 diligence.

4 An effective risk management process
5 throughout the life cycle of the relationship includes
6 planning, due diligence, and third party selection,
7 contract negotiations, ongoing monitoring, and
8 termination of the agreement, and our guidance goes
9 into great detail as to what we mean by all those. So
10 I won't go into any detail here.

11 The risk management program needs to consider
12 outsourcing should result in a strategic benefit to the
13 bank. The more strategically aligned the services
14 being provided, the more critical the third party
15 becomes to the institution.

16 Management should have effective change
17 management processes to allow for the third party to
18 function appropriately. Clear roles and
19 responsibilities for overseeing and managing the
20 relationship and the risk management process needs to
21 be established.

22 We expect the board oversight. We expect

1 policies and procedures. We expect a proper framework
2 for overseeing the complexities that come from working
3 with third parties, and there is no one way of doing
4 it. Some banks have very structured centralized
5 processes for monitoring the relationships, others are
6 very de-centralized.

7 The ones that I find that are the better ones
8 are the ones where it's holistically part of the
9 culture of that institution to be able to say, okay,
10 these are our service providers, how can we monitor,
11 and it goes all the way from the board down to the
12 lowest rank of the organization to be able to have a
13 voice in how well that relationship is working.

14 Again, the more critical relationship, the
15 more oversight required. Third party relationships
16 work best when the cultures are aligned, making sure
17 that the third parties have the same cultural
18 expectations and norms as the institution, the bank.

19 We do expect good documentation to support
20 the decisions that are being made throughout the life
21 cycle of the process as well as the selection of the
22 contract and everything else. We do expect to have

1 good ways of tracking those decisions.

2 We also expect banks to have independent
3 review and by that, I mean have that process audited
4 periodically to make sure that it's functioning
5 appropriately.

6 And we have other guidance that as may be
7 applicable. The FFIC has a great deal on the IT side
8 and we have other guidance, such as model risk
9 management, which I'll flash on the screen later.

10 The key to good governance, too, is making
11 sure that everybody is at the table at the same time.
12 This is not something that can be delegated to one
13 person to make the decision for the institution. You
14 need to look at this holistically across the enterprise
15 and make sure that all the divisions are represented
16 and make sure that the selection is reflective of the
17 needs and the issues that are being seen at the
18 organization.

19 Those that have the compliance, the audit,
20 the credit, the liquidity personnel at the same time
21 making that decision typically make a better decision
22 than those that are just relying on one person, one

1 committee.

2 So, anyway, those are just some of the key
3 points that I just wanted to make and I also wanted to
4 let you know the various issuances that we have. We
5 have specific guidance on third party risk management.
6 We have the circular, as I said. We also have FAQs on
7 the subject and we have provided examiners with
8 examination procedures.

9 We also have guidance on new product services
10 in development, a model risk management, which touches
11 on third parties, and also our Corporate and Risk
12 Governance book on the Comptroller's Series talks
13 greatly about risk management and how to develop proper
14 risk management programs.

15 Thank you.

16 MS. HUNTER: Thank you, Lazaro.

17 Next, we'll hear from Julie Mohr, Deputy
18 Director, Examinations, Division of Clearing and Risk,
19 for the CFTC.

20 MS. MOHR: Good afternoon.

21 As Annette just said, I'm Julie Mohr. I'm
22 the Deputy Director in charge of the Examinations

1 Program for Derivatives Clearing Organizations,
2 including those clearinghouses that have been declared
3 systemically important by the Financial Stability
4 Oversight Council.

5 But I'll start with the normal disclaimer.
6 The views that I express this afternoon are my views
7 and they do not necessarily reflect the views of the
8 Commission or the staff.

9 I want to first thank Commissioner Behnam and
10 Alicia for this invitation to discuss this very
11 important risk management topic.

12 The discussion is timely as the incidents
13 that result in highly-publicized events are numerous.
14 We have all read stories about malware attacks or other
15 types of attacks on software or hardware produced by
16 third party vendors where credit card information or
17 other sensitive documents have been taken.

18 DCOs work with sensitive information in order
19 to complete their required activities and as a result,
20 we have an examination program that focuses on DCO
21 vendor risk management.

22 DCR's program is built around safety CU

1 regulations and industry best practices. Our
2 regulations state that a DCO must establish and
3 maintain resources that allow for the fulfillment of
4 each obligation and responsibility of the DCO in the
5 processing, clearing, and settlement of transactions,
6 and that the DCO must maintain resources necessary to
7 complete its obligations using either its employees and
8 its own property or through written contractual
9 arrangements with other DCOs or other service
10 providers.

11 A DCO that enters into a contractual
12 outsourcing arrangement must retain responsibility for
13 any failure to meet its obligations and, lastly, the
14 DCO must have personnel with the expertise necessary to
15 enable it to supervise the delivery of services by a
16 service provider.

17 For all items underneath Regulation 3918, and
18 that's our system safeguard regulation, the standards
19 for the DCOs program of risk analysis and oversight
20 with respect to its operations and automated systems
21 shall follow generally accepted standards and industry
22 best practices as it relates to the development,

1 operation, reliability, security, and capacity of its
2 automated systems.

3 The generally accepted standards and industry
4 best practices that we typically look to include NIST,
5 FFIC, ICO, and COBIT, but these are just a few.

6 Prior to initiating the examination, we
7 perform a risk assessment to identify those
8 arrangements that we may want to examine. Perhaps we
9 would like to review the arrangements for vendors who
10 provide IT, independent IT security clearance services,
11 such as pen testing or controls testing. Maybe we
12 would like to review the arrangements for vendors who
13 provide IT services, such as software development or
14 data center services.

15 We may even want to take a look at
16 arrangements for vendors who provide settlement
17 services or margin modeling services. Once we have
18 risk ranked the vendor arrangements we would like to
19 include in our scope, we would then take a look at
20 which relationships contain the highest risk. Those
21 high-risk relationships are likely to be those that we
22 would examine.

1 We request documentation that may include one
2 or more of the following items: the policies or
3 procedures that describe its vendor risk management
4 program, any assessments regarding the independence of
5 vendors. We want to make sure that the person that is
6 looking at the -- that's being hired to look at a
7 particular item is not involved in the design or the
8 development or the maintenance of the particular item
9 that's underneath review.

10 We also look at the qualifications of the
11 vendor. We look at the terms of the contract,
12 including all service level agreements. We also look
13 at how the DCO prioritizes the vendor's information
14 security systems, components, and services.

15 In addition, we will look at any reports that
16 reflect whether or not SLAs are being monitored and
17 met.

18 Now we study these documents before we go
19 onsite to meet with middle and upper management who are
20 in charge of the vendor relationships and the
21 management of those relationships. Those sessions help
22 us understand the processes being utilized, the

1 analysis that's been performed surrounding the vendor,
2 and the performance of the vendor.

3 Our goal is to identify any area within the
4 vendor relationship that has not been adequately
5 reviewed and assessed. Issues that are identified are
6 communicated to the DCO and the DCO will work on
7 remediation plans to address the deficiency.

8 The DCO will submit remediation plans to DCR
9 and we will identify those plans in an effort to see if
10 the solution will resolve the issue that was
11 identified, and we will continue to monitor the issue
12 until we have seen complete remediation of the concern.

13 Thank you.

14 MS. HUNTER: Thank you, Julie.

15 Next, we'll hear from Salman Banaei, IHS
16 Market.

17 MR. BANAEI: Thank you, Alicia, and thank
18 you, Commissioner Behnam, for inviting me to speak.

19 I think you guys brought me as the sole third
20 party vendor for this panel. I can't purport to say
21 that I can speak for all the vendors out there, but
22 what I can present is a view from one of the larger

1 FINTECH service providers that's out there.

2 So to give you a little bit of context in
3 terms of who we are as a firm, so I just market as a
4 \$21 billion market cap public company. Of that 21
5 billion, about 40 percent of our revenues come from our
6 financial services business and when you look at our
7 financial services business, it's a wide array of
8 FINTECH products, many of them relevant for the CFTC's
9 mission, many of them relevant to other asset classes.

10 Thank you. Before I start, I want to create
11 two new terms just for clarification purposes. So the
12 first is direct regulations. So direct regulation is
13 when an entity is under the direct regulatory or
14 supervisory jurisdiction of a particular regulator.

15 And then I want to introduce a more novel
16 term, which is indirect regulation, and this is an
17 instance where an entity is supervised or otherwise
18 scrutinized by a firm that is itself regulated
19 consistent with that firm's regulatory requirements.

20 The reason I bring that up is while some of
21 the services we provide particularly relevant to the
22 CFTC's mission are not directly regulated, they are

1 certainly indirectly regulated and that's an important
2 distinction to make.

3 But stepping back, so what is FINTECH? The
4 FSB definition, I think, is a useful one from 2017.
5 FINTECH is a technologically-enabled financial
6 innovation that could result in new business models
7 application processes or products with an associated
8 material effect on financial markets and institutions
9 and a provision of financial services.

10 The OCC's third party risk management
11 guidelines includes some discussion of expectations
12 around risk management associated with FINTECHs, in
13 addition to other services.

14 So who are we? So this is a subset of the
15 services that come out of IHS Market financial markets
16 roughly in order of the number of due diligence
17 inquiries we get from our regulated customers.

18 So there's our post-trade business that's our
19 loan processing and clearance and settlement business,
20 I'm involved in that effort, as well as our derivatives
21 processing platform, capturing trades, providing a
22 means to confirm those trades, providing connectivity

1 to clearinghouses, and also providing regulatory
2 reporting services and that's probably the most
3 important service that we provide for the CFTC
4 regulated markets.

5 And then another important set of products
6 that we provide across asset classes is our pricing and
7 valuation services as well as our reference data
8 business, our indices, our benchmarks businesses, and
9 then we have a number of managed services, some of
10 which could be called direct tech regulatory
11 technology.

12 These include platforms that facilitate
13 compliance with KYC requirements as well as Know Your
14 Third Party, KY3P, requirements that our customers are
15 subject to.

16 Just very quickly, also provide Market
17 Digital, which is a website hosting content provision
18 for including advisory tools for broker-dealer retail
19 customers.

20 So why do firms outsource to FINTECH
21 companies like us or third party service providers in
22 general? Lower cost is a big driver. So we can

1 provide skill that an in-house solution just is not
2 capable of. This is particularly true when a
3 particular function is not really a value-generating or
4 differentiating function for a particular company. So
5 a lot of times, it makes sense to socialize those costs
6 through a FINTECH service provider like us.

7 We can offer, because we're subject to market
8 discipline, to deliver at a lower cost. We're also
9 subject to market discipline to deliver that product at
10 a higher level of performance and with greater
11 efficiency.

12 And then, of course, there's the opportunity
13 cost of, you know, developing an in-house solution for
14 a particular challenge.

15 I don't know why I put this slide in, but
16 this is Google Trends. The term "FINTECH," you can see
17 really picking up 2014. I like the term. It's a good
18 shorthand for the ecosystem of financial technology
19 providers.

20 So as a firm that's both, you know,
21 indirectly and directly regulated FINTECH service
22 provider, it's required us to think, you know, a little

1 bit more deeply about regulation and what it means,
2 what its benefits are, what its costs are, what its
3 impacts are on a particular business, and we've
4 derived, you know, five principles that I think
5 generally apply to the oversight of third party service
6 providers.

7 These could be used by one of our customers
8 that's scrutinizing us or they could be used as a basis
9 for a regulator trying to formalize their approach to
10 third party oversight.

11 So the starting point, and this echoes
12 Julie's comments and Lazaro's, too, the starting point
13 is documenting. It's very important to document all
14 material relationships so you can hold both the
15 customer and the third party service provider
16 accountable for and allocate rights and
17 responsibilities. It's very important to document
18 those, make those explicit.

19 Another principle which, you know, needs --
20 is of general application and is a great starting
21 point, I don't think it's an end point in all
22 instances, is that non-discrimination.

1 So third party service provider should
2 generally not be subject to less oversight or lower
3 standards than an in-house function. I call this the
4 floor of third party oversight expectations and then
5 the ceiling would be third party should not be subject
6 to more oversight or higher standards than a similar
7 in-house function.

8 There should also be open dialogue. I think
9 the CFTC does a terrific job at this. I can't say the
10 same for all regulators but there should be open
11 dialogue. It should be encouraged at all levels, both
12 on the private industry side among the third party
13 service providers as well as the regulators.

14 From a third party service provider
15 perspective, it's helpful for us to engage with the
16 regulators so that we can deliver our services in a
17 compliant way and not have to rely solely on our
18 customers.

19 Responsiveness. So I think the CFTC again
20 does a great job here through the MRAC, at the
21 Commission level. Regulators should be responsive and
22 encouraging of new approaches and new technology and

1 not unduly burden commerce and innovation. The basic
2 idea of a regulatory tradition should be a basis for
3 regulating innovation, not a barrier to innovation.

4 And then lastly, this is an important
5 principle for all regulation is proportionality. So
6 oversight expectations, regulations should be
7 proportionate to the extent of reliance and the risk
8 associated with a particular service and under certain
9 circumstances that may require extra validation, for
10 example, external audit of relevant controls.

11 So when does it make sense to directly
12 regulate a FINTECH? So here, I've really just
13 presented my inferences based on my knowledge of other
14 financial regulators approaches to regulation and their
15 organic statutes.

16 So one rationale is to ensure that
17 appropriate conduct -- that a particular firm is
18 applying the appropriate conduct for a significant
19 fiduciary or customer relationship.

20 Second is to ensure the integrity,
21 operational integrity or price discovery function of a
22 particular venue. Another is to ensure appropriate

1 risk management for central risk notes. Another is to
2 mitigate substantial operational risk, then is to
3 facilitate commerce, for example, to provide real
4 certainty for businesses that would benefit from it.

5 And then what's the rationale not to
6 regulate? Avoiding barriers to entry, encouraging
7 innovation, competition, and regulation of a particular
8 service would be disproportionate.

9 So CFTC right now has an approach to better
10 risk management that I think is a fair balance between
11 all those countervailing principles that I discussed
12 earlier and it may decide to adopt a new approach. If
13 it does, you know, it can, for example, provide written
14 policy guidance for registrants' management of third
15 party risk that maybe fleshes out those expectations
16 along the lines of the level of detail that the OCC has
17 provided. It can encourage certifications or external
18 validation.

19 We as a firm, we're set to submit about 6,000
20 responses to our regulated customers in response to due
21 diligence inquiries that come out of primarily
22 regulators' expectations for those firms this year and

1 that's coming from 929 firms and we have a staff of
2 about 10 people whose job it is to provide those
3 responses.

4 I think we're large enough that we see the
5 value of providing these assurances to our customers,
6 but I think a lot of the smaller FINTECH players, this
7 is a burden and a barrier to entry. From our
8 perspective, we welcome it, but, you know, smaller
9 firms may have a different opinion and I would advise
10 before the CFTC formalizes its approach to vendor risk
11 management that they also engage with some smaller
12 FINTECH firms, as well.

13 And then there's, of course, you know, direct
14 regulation that the CFTC could undertake through its
15 existing authority as well as direct regulation through
16 authority which would probably require legislation.

17 That concludes my remarks.

18 MS. HUNTER: Thank you. So I will start the
19 questions and then hopefully the rest of the members
20 can join in.

21 So because we've got a variety of panelists
22 here, I'm going to ask this. Have you experienced or

1 observed any examples of vendor risk operational losses
2 or incidents and how are they dealt with?

3 MR. BARREIRO: We see it almost every day.
4 Every time we look at the newspaper, we're seeing
5 something regarding credit cards or a whole litany of
6 things that could happen. Just the other day,
7 yesterday, I guess, Marriott, 500 million, even though
8 it's not a banking institution, and I think one of the
9 biggest threats or the biggest exposure to some of the
10 banks is the headline risk that they're seeing that's
11 really very difficult to quantify how do you put a
12 price tag on that exposure that you're getting.

13 In terms of other exposures, I mean, it's one
14 off. There's nothing really to stomach. You just
15 address the issue, try to come up with a loss figure,
16 and you try to go forward. So I know I'm being very
17 general here. It's difficult to talk about one
18 particular institution, but I don't know if anybody
19 else can add any more insight into that.

20 MR. BANAEI: I can provide an observation.
21 So we are currently a Conduct 3 firm, registered with
22 the FCA, and at the core of our regulatory relationship

1 with the FCA is notifications of whenever we have, you
2 know, an operational issue and we do that periodically.
3 I think that's a good starting point for, you know,
4 firms that play a similar function for us is to have an
5 open dialogue around operational failures and have a
6 constructive conversation with our regulators.

7 Those events, by the way, don't happen very
8 often, you know. I'd say more than, you know, a few
9 minutes happening one or two times a year, but it does
10 happen. It happens with all of the regulated firms
11 that we connect with, as well.

12 MS. LEWIS: Thank you.

13 Well, I wanted to open it up to the MRAC for
14 any questions or comments on this particular topic.

15 Betty Simkins, Oklahoma State University.

16 DR. SIMKINS: I want to thank Commissioner
17 Behnam and Alicia Lewis and the CFTC broadly for
18 holding these important meetings and as part of the
19 committee, I just want to emphasize that I believe that
20 improvements in risk disclosures are needed and
21 financial statements.

22 I've been doing research for like over 26

1 years on market risk, enterprise risk management, more
2 recently in energy risk and cyber risk very recently.

3 Today, you know, we've heard repeatedly many
4 keywords and phrases, communications, transparency,
5 skin in the game, good governance, enterprise risk
6 management, cyber risk, best practices, and others.

7 You know, from my cyber risk research, which
8 includes many firms broadly, but it also includes firms
9 covered by the CFTC and when I look at the 10-K
10 disclosures and the proxy statements and I was looking
11 at them today when I got out my laptop just to see, you
12 know, in the financial statements from the public
13 perspective because public was mentioned several times
14 today, you know, we find boilerplate disclosures that,
15 you know, you would see like the Big 4 accounting firms
16 across them just -- they're very generic and so it
17 concerns me from a public perspective that it's not
18 clear that there's adequate risk management taking
19 place.

20 Let's just take cyber risk, for example. Yet
21 we've had a lot of rich discussion today that, yes,
22 there appears to be. My research more recently that

1 I'm looking at is after a cyber breach, we look at the
2 risk disclosures before and we look at the after and
3 even after the cyber risk, there's some companies
4 that's totally missing that they're doing anything to
5 address it and even some of these companies are, you
6 know, under the oversight of the CFTC and so the
7 follow-up's not there.

8 I think I like the idea of best practices
9 encouraged, you know, by the CFTC. I'm not here to
10 propose more regulation, like was mentioned earlier.
11 If self-regulation could hopefully be done just to
12 improve -- make improvements in this area and so
13 there's just some broad comments I wanted to make.

14 Thank you.

15 MS. LEWIS: Thank you, Betty.

16 Commissioner Behnam.

17 COMMISSIONER BEHNAM: I'm interested to know,
18 and this kind of goes back to the non-default loss
19 conversation from the members, if you're willing to
20 share, participate, to the extent that do you believe
21 -- and I understand that each and every enterprise
22 organization or franchise has its own vested interests

1 in protecting its third party vendor relationships. I
2 think that sort of statement can be broad and applied
3 to most of the sort of risk management that you all do.

4 But from our perspective, and the Chairman
5 and I have spoken about this, you know, and Julie
6 mentioned it. We specifically have Julie here from DCR
7 because DCR does have some sort of element of third
8 party vendor relationship guidance which she's pointed
9 out.

10 But there are pockets within the CFTC's
11 overarching rules and regulations where we do think we
12 should, at least I do, I'm not going to take the we
13 back, I think that this is a conversation worth having
14 because there may be pockets that I believe the
15 Commission should step in and think about as technology
16 advances and changes and evolves on a daily basis.

17 So from a market participant standpoint,
18 again if anyone's willing to share, going back to the
19 non-default loss conversation, do you think existing
20 rules, guidance, or principles that may already exist
21 from any number of banking regulators or oversight
22 regulators is appropriate or do you think there is room

1 for improvement and growth in that space, given how
2 much the market's changing?

3 And then, I guess, you know, more specific to
4 the CFTC, do you feel more third party vendor
5 management, guidance, principles, or rules should be
6 appropriate or thought about in the future?

7 MS. LEWIS: Salman Banaei, IHS Market.

8 MR. BANAEI: So we think, speaking for IHS
9 Market, we're under adequate scrutiny from our
10 regulators and from our customers. As I mentioned, you
11 know, 6,000 responses this year.

12 I didn't mention we also provide our
13 customers that ask for it the results of an external
14 audit we conduct every year that looks into our
15 controls and ensures our operational performance in
16 line with our customers' operational requirements.

17 So we think, you know, market discipline with
18 the reinforcement of banking regulators in particular
19 providing additional reinforcement is adequate but we
20 would not be opposed to a more direct, you know,
21 supervision from a market regulator, like the CFTC, so
22 long as, you know, the principles that I described

1 earlier are more or less followed, particularly the
2 ones in and around proportionality.

3 MS. LEWIS: Thank you, Salman.

4 Craig Messinger, Virtu Financial.

5 MR. MESSINGER: Commissioner Behnam, I think
6 the way I'd answer your question is guidance
7 definitely, regulation's tricky because you need to be
8 careful that regulation doesn't hamper innovation, and
9 I think what's going on in the marketplace in many
10 cases is, you know, first of all, the laws as it
11 relates to data and privacy are not really granular
12 right now. They're not well understood. They're being
13 interpreted differently around the world, which creates
14 an interesting challenge.

15 You can go to a country like Singapore where
16 it's prescriptive and you can go to a country like the
17 United States where it isn't as much so and innovation
18 is happening a lot.

19 So my feeling is that best practices and
20 guidance is always good. Just be careful with where we
21 trip into the regulatory side.

22 The other thing is market structure is

1 changing across every asset class and, you know, many
2 times you feel like we're trying to equitize, for
3 example, fixed income and the product just doesn't fit
4 there, as well. So I think we just need to be very
5 careful as we approach these different markets.

6 MS. LEWIS: Thank you, Craig.

7 Frank Hayden, Calpine Corporation.

8 MR. HAYDEN: I would like to thank the
9 Commission for hosting this discussion on this very
10 important topic. Thank you.

11 So tying into this non-default loss concept
12 and this idea of the first loss, I mean, from my
13 perspective, if it's your job that you failed at, you
14 should eat that loss and so from the vendor
15 relationship, this relates to late trades, fat fingers,
16 you know, not being able to model a deal, not being
17 able to put stuff in, absolutely, they should eat that
18 problem. I mean that's their problem, right.

19 If it relates to something more systemic,
20 like, you know, there's a down service attack or
21 there's some sort of, you know, massive hack going on
22 and the systems go down, it's a different problem in

1 nature and so I think it's important when you start
2 thinking about the various risks the vendors face that
3 you break up the various buckets of that.

4 So some operational risks are strictly
5 related to what I would call incompetence, like they
6 can't value a deal. They take two days to run a Monte
7 Carlo because it gets hung up because they can't figure
8 out how to do a correlation matrix, right, or they
9 can't input a new product. The trader comes, hey, I
10 want to trade something new and they can't figure out
11 how to put it into the system and it just sits there in
12 a drawer. The market moves and then when it shows up,
13 they're like, you know, millions of dollars out of
14 market because of that, you know, inability to track a
15 transaction, right.

16 So I think that there's certain things that
17 definitively fall on the vendor that the vendor needs
18 to be better at doing and better at delivering and
19 then, on the other hand, I think there's other things
20 that just really come down to the company who hired the
21 vendor just being incompetent in their processes and
22 from that perspective, you know, that's easy bait for a

1 first loss, in my view, on the NDL stuff.

2 MS. LEWIS: Are there any members on the
3 phone with questions or comments?

4 (No response.)

5 MS. LEWIS: Salman Banaei, IHS Market.

6 MR. BANAEI: I just want to echo the
7 gentleman from Calpine's comments and emphasize an
8 important point, which is any vendor, any FINTECH
9 vendor, any other vendor operates in a free market,
10 operates subject to market discipline.

11 So if they don't deliver in a way that their
12 customers expect, they go out of business. That's an
13 important point, I think, to make. If the CFTC thinks
14 about whether new guidance or new policy in this area
15 is necessary because market discipline regulates all
16 markets and, you know, more or less a fairly good job
17 in certain circumstances. In other circumstances, you
18 know, it does require regulatory intervention, and it's
19 up to the CFTC to decide.

20 MS. LEWIS: A quick question for the CCPs and
21 trading platforms in the room with respect to
22 concentration risk. You know, a vendor that is used by

1 the CCP is also used by a clearing member. What are
2 your thoughts on concentration risk? I have a taker.

3 Derek Kleinbauer.

4 MR. KLEINBAUER: Thank you.

5 I would say as a SEF, we have an obligation
6 to get a trade from the execution point down to the
7 clearinghouse and while not necessarily focusing on
8 concentration risk, I will say we are required to use
9 the platforms and services that our participants elect
10 to use and we have a responsibility to support that.

11 What I will say is to get from point A to
12 point B, we're providing that service but we're also --
13 we also have several external touch points that we're
14 going to as a result of the customer's choice.

15 So while we're under the, you know, scrutiny
16 of getting that trade to the destination, whether it's
17 the CCP and then following that the STR, we would hope
18 that any services that we leverage on behalf of our
19 customers also faces the same level of scrutiny and
20 oversight because it is part of that workflow.

21 MS. LEWIS: Bis Chatterjee, Citigroup.

22 MR. CHATTERJEE: Thank you, Alicia.

1 I think I just want to build on your
2 question. I think the importance of, you know,
3 understanding vendor concentration is important between
4 CCP and clients.

5 I think it's also important across the CCP
6 ecosystem the same vendor may be servicing multiple
7 clients. So to the extent you have either a temporary
8 outage or a multiday outage in a vendor, I think it's
9 very important for this committee and maybe the
10 division to look at where those concentrations or
11 blocks exist in the entire clearinghouse scenario.

12 MS. LEWIS: Thank you, Bis.

13 Dale Michaels, OCC.

14 MR. MICHAELS: There is one thing that we
15 look at as far as the concentration. We look at the
16 futures side. There are basically two back office
17 vendors. One of them which has the majority of the
18 business, and you have to look at that and make sure
19 that they have the business continuity in place, that
20 they have the operations, that they have additional
21 staffing.

22 On the security side, there is basically one

1 large facilities management business, if you want to go
2 into that realm, again where from our standpoint we
3 have to look at again their business continuity, their
4 staffing, look at what they have as far as plans, and
5 look at the actual sites that they have.

6 So it does put an extra onus on, I think, not
7 only the CCPs but the clearing members to do their due
8 diligence all around because we all know who we're
9 speaking about here to make sure that because there is
10 this concentration and it has evolved over the years to
11 this select few and we're not going to get away from
12 it, we just have to be very proactive to understand it
13 and then to try to mitigate as best as we can.

14 MS. LEWIS: A follow-up question to that.
15 Would it be beneficial to have minimum standards or
16 guidelines in terms of how to manage that relationship
17 from the CFTC?

18 MR. MICHAELS: I don't know if it's -- the
19 guidelines for this one is needed. I kind of go back
20 to Craig's point earlier.

21 Guidelines are always welcome. I mean, I
22 think it's welcome to talk about it with the whole

1 community so that we're knowing what the clearing
2 members are doing, CFTC understands what they're doing,
3 CCPs. I think that communication's important. I get a
4 little bit leery when you get into where you take the
5 guidelines into regulatory prescription because I don't
6 think we want to say, well, we have to have so many
7 different vendors.

8 This evolved in this direction for a reason.
9 It's a business that it's maybe not as attractive for a
10 lot of folks to be in it because it does require scale
11 and that type of scale can only fit for one or two
12 members.

13 MS. LEWIS: Thank you, Dale.

14 Demetri Karousos, Nodal Exchange.

15 MR. KAROUSOS: Thanks, Alicia.

16 Just to address your question from our
17 perspective, it's a complicated question because there
18 are lots of services that we use. So I'm thinking of
19 at least three different areas, so one is the ISB story
20 that was just discussed.

21 From our perspective, while they have massive
22 market share, the key ISBs in the futures industry,

1 most of the services they provide, we provide redundant
2 services for. So anything, whether it's pricing
3 positions, trade confirms, whatever, there are multiple
4 ways to ensure that that gets to the clearing members,
5 that gets to the participants. So there's no single
6 point of failure that we're concerned about on the key
7 data being communicated to our clearing ecosystem.

8 Another concentration area is where clearing
9 members request that they act as -- that an affiliate
10 acts as their own settlement bank. So that's a key
11 scenario that we have to map out in our recovery and
12 wind-down plan and again the most I can say there is
13 that obviously there's lots to say about clearing
14 member failures that we all will understand when a
15 settlement goes down and they're not providing much in
16 the form of custodial services but just settlement
17 banking services itself.

18 We have multiple settlement banks to rely on
19 to get through a margin run and proceed, so that one
20 doesn't terrify us as much either, and then the third
21 one is what I focused on earlier, which is the
22 concentration that occurs on the custodial side that we

1 wish we had other solutions. So I think I've already
2 addressed that.

3 MS. LEWIS: Thank you, Demetri.

4 Lee Betsill, CME.

5 MR. BETSILL: I'll just add briefly to the
6 points made by Demetri and Dale, that we do have as
7 part of our obligations the obligation to identify
8 critical service providers as part of our recovery
9 planning, right, and where we do identify those
10 critical service providers for which concentration may
11 be one of the reasons we identify them, we do hold
12 those to a higher standard. So we perform due
13 diligence on a more detailed and more regular basis
14 than non-critical vendors, just to make that point.

15 MS. LEWIS: I'm sorry. My microphone was not
16 on.

17 And that concludes Panel Number 4. Many
18 thanks to our speakers. Thank you, Annette, for
19 facilitating.

20 And now we will have Closing Remarks. We'll
21 start with Chairman Giancarlo.

22 Closing Remarks

1 CHAIRMAN GIANCARLO: Thank you, Alicia.

2 Extraordinary hearing today, everybody. A
3 lot of complex and complicated issues that require
4 careful balancing that are all ones of matters of
5 degree, whether it be systemic stability on one hand,
6 market vibrancy on the other, concerns of major market
7 participants or smaller market participants, cleared
8 versus uncleared products, different views on skin in
9 the game whether from CCPs or the clearing members or
10 other market participants, issues of market
11 concentration and, as Salman has now coined a phrase,
12 direct regulation, indirect regulation. So a lot of
13 really complex issues, certainly much more to do for
14 MRAC and for its various subcommittees, and much for
15 the Commission to mull over and think about it in the
16 time to come.

17 As Commissioner Behnam began in his opening
18 remarks and echoing some points I've made recently, the
19 work of regulation is never one and done. It's an
20 ongoing process. Markets are organic things. They
21 grow, they change, and they develop, and they evolve,
22 and throughout that evolution, you as market

1 participants and we as market overseers have a constant
2 job to stay up to speed on these changes and to adjust
3 and react and try to stay ahead so that our markets
4 remain as vibrant and yet as systemically sound and
5 stable as we can get them to be.

6 So certainly things are not done 10 years
7 after the financial crisis or to use Bob Wasserman's
8 colorful analogy, a hundred years after the Maginot
9 Line was breached. So things are not done. There's a
10 lot more to do, but, fortunately, we have all of the
11 input from all of you, very thoughtful, fact-based,
12 well-informed, intelligent, and really constructive,
13 and so certainly my gratitude, the gratitude of the
14 entire Commission.

15 I know Commissioner Behnam will express his
16 gratitude but our gratitude really for bringing it to
17 these meetings. It really, really helps us and I think
18 this probably will be the last formal meeting of any
19 group this year, certainly the last time Commissioners
20 and I will be here on a dais in front of you as we
21 close out 2018.

22 So I wish you all the best, the happiest of

1 holidays, and for those who celebrate Hanukkah, which
2 has already started, Happy Hanukkah, and put your
3 seatbelts on, 2019's going to be a busy year, and we'll
4 look forward to seeing all of you here for more
5 thoughtful consideration of these issues.

6 Thank you.

7 MS. LEWIS: Thank you, Chairman Giancarlo.

8 Commissioner Behnam.

9 COMMISSIONER BEHNAM: I will be brief.

10 Thanks to all of you for being here. Like I
11 said in my opening remarks, we started with bit coin
12 and then we turned to Libor and now we largely wrapped
13 up with CCP risk management, which it's been a big year
14 and we have a lot ahead of us.

15 Today's conversation was excellent, you know,
16 reiterated the Chairman's points, a lot to unpack,
17 which I will do personally. We'll stay engaged with
18 the committee members if there's things to follow up
19 on.

20 Obviously the first three panels are issues
21 that this committee has discussed extensively but, you
22 know, I don't mean to suggest not enough. We always

1 have to stay on top of these issues but something that
2 I think is important from a policy-making standpoint.
3 We need to convene. We need to discuss important
4 issues, but we also need to produce deliverables.

5 There certainly are a lot of issues that were
6 discussed on the first panel for sure but also the
7 second and third, which are not easy questions.
8 They've been questions that this Commission and all of
9 you have dealt with for many years and there is a
10 little bit of friction between, I think, in my opinion,
11 our role vis a vis the market's role and how that
12 relationship should exist.

13 That said, I think I did hear a few things
14 today and we'll take them back for the new year and
15 think about if there's a way to dig a little bit deeper
16 and find solutions. I think we have a lot of
17 reasonable people in this room who represent a lot of
18 different organizations across a whole spectrum of the
19 industry and in my mind a lot of, I think, fair heads
20 can sort of come out on top here and we can find
21 consensus and some solutions to problems that I think
22 would be small steps towards a safer, better, more

1 resilient market.

2 I want to say a couple more things. On the
3 FCM concentration, we heard it multiple times today
4 from folks on this side of the table and around the
5 room. Tough issue for sure and one that I think
6 personally I've dealt with for a number of years. It
7 is a tough balance where it feels like a zero sum.

8 Marcus, I'm thinking about what you said
9 about capital treatment. Obviously, credit risk
10 methodology is another sort of proposed solution, but I
11 don't think we have any clear idea of how any of these
12 possible ideas will resolve, if at all, this
13 concentration issue.

14 So we all have to be reasonable. We all have
15 to be thoughtful, and even though we might fear a
16 policy decision creating a new risk in a different
17 space, I think the concentration issue is a real
18 problem. It's one I know the Chairman's spoken about a
19 lot. I've spoken about it. I spoke about it at
20 Chicago Fed in October.

21 So we need to keep thinking about it because
22 it's a core fundamental part of our market and we need

1 to provide, John, as you pointed out, our end users,
2 and Boog pointed out, an ability to clear and use our
3 markets for risk management.

4 On this last panel, you know, it's like I
5 mentioned in my opening remarks, thanks to the three
6 panelists here, a lot to work through and this is just
7 a starting point.

8 Craig, appreciate your point and the points
9 on the follow-up. I understand that I need to be
10 thoughtful about this and these are only ideas that I'm
11 going to sort of digest and potentially present to the
12 Chairman at some point in the future, but there's a lot
13 of work to be done and I appreciate the principles-
14 based approach as this agency has done for decades and
15 it's probably the one that best suits the marketplace,
16 both from an innovation standpoint and sort of a best
17 practices standpoint.

18 So I will end that. Thanks to all the
19 moderators, Robert, Isaac, Alicia, Annette. Thanks to
20 all the members for showing up. Bob Wasserman, thanks
21 for the Wasser cakes, of course. Of course, thank you
22 to the Chairman for his work, his attendance, and

1 Commissioners Stump and Berkovitz for their time to be
2 here for most of the afternoon.

3 It's a long day, but we have a lot to look
4 forward to in 2019. My general idea, I know this is
5 always -- I don't want to corner myself here, but
6 looking at May and November, so two meetings for sure,
7 we won't do more than that, but those seem to be times
8 of the year that we can get folks down in D.C. and
9 spread out enough where we can have thoughtful
10 conversations as we always have.

11 My door's always open. Feel free to reach
12 out. I have a big spreadsheet of ideas that you all
13 proposed. This committee is its members. So we will
14 discuss issues that you care about and as I and Alicia
15 continue to think about those issues in the next months
16 ahead, we'll start to finalize what the issues will be
17 in 2019.

18 And, finally, thanks to Alicia for all of her
19 hard work. Not much else needs to be said about this
20 committee and how it runs so smoothly and that is in
21 large part, if not all, due to her work.

22 So Happy Holidays, best of the new year, and

1 look forward to seeing you all very soon.

2 Thanks.

3 (Applause.)

4 MS. LEWIS: Thank you, Commissioner Behnam.

5 I wanted to thank everyone for attending our
6 third and last MRAC meeting of 2018.

7 Happy Holidays. The meeting is now
8 adjourned.

9 (Whereupon, at 4:08 p.m., the meeting was
10 adjourned.)

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