U.S. COMMODITY FUTURES TRADING COMMISSION (CFTC)

GLOBAL MARKETS ADVISORY COMMITTEE (GMAC)

Tuesday, September 24, 2019

9:33 a.m.

Commodity Futures Trading Commission - CFTC

Three Lafayette Centre

1155 21st Street, N.W.

Washington, D.C. 20581

BEFORE:

Dawn DeBerry Stump, GMAC Sponsor and Commissioner, CFTC

Angie Karna, Chairperson

ALSO PRESENT:

Heath P. Tarbert, Chairman, CFTC

Brian D. Quintenz, Commissioner, CFTC

Rostin Behnam, Commissioner, CFTC

Dan M. Berkovitz, Commissioner, CFTC

AGENDA

AGENDA (Continued)

P R O C E E D I N G S

MS. GOLDSMITH: Good morning. Welcome to the Global Markets Advisory Committee meeting. As the Designated Federal Officer, it is my pleasure to call this meeting to order. We are very much looking forward to today's presentations and discussions. I just want to go through a couple logistical items before we start.

Please ensure that your microphone is on before you speak, and that is done just by simply pressing the button. When you speak, please speak clearly into the microphone. This will allow both the webcast audience and those participating by phone to hear you.

In addition, if you would like to be recognized during this, the discussion, please change the position of your name tent so that it sits vertically on the table in front of you. The chair of the meeting will recognize you and give you the floor.

I would like to turn it over now to the GMAC sponsor, Commissioner Stump, who will give her opening remarks.

COMMISSIONER STUMP: Thank you, Andrée.

Good morning. Welcome to our second GMAC meeting of 2019. I want to begin by welcoming Chairman Tarbert. It is quite appropriate given his background in international matters, that his first advisory committee meeting as chairman of the CFTC has a global focus. And we are thrilled that he is here, very fortunate to have his expertise here at the CFTC.

I also want to thank Commissioners Quintenz and Behnam for being here today as well as Commissioner Berkovitz for his engagement via webcast. I know that your contribution to the discussion will be appreciated by all of the participants.

I also want to thank all of the members of GMAC for making an effort to be here, both in person and on the telephone, and to the panelists for all of their efforts in putting together the presentations. I know it is no small task, and we are very appreciative for your participation.

And, lastly, I want to thank the Designated Federal Officer for GMAC, Andrée Goldsmith, for all of her efforts and her energy and her attention to all of the details for this meeting. It is greatly appreciated.

At the GMAC meeting in April, we covered a wide variety of issues that made up the key pillars of the 2009 Group of 20 Leaders' directive regarding the OTC derivatives markets. My goal today is to use that discussion as a jumping-off point for today's agenda. Specifically, today's presentations will delve deeper into two specific topics that we touched on in April: one, the global process applied to implementing initial margin for non-centrally cleared derivatives and how the phasing of such has progressed; and how clearing through central counterparties has evolved since the crisis. Regarding clearing, we will specifically discuss European legislation known as EMIR 2.2 as it relates to non-E.U.-based central counterparties, including those under CFTC registration. Regarding the exchange of initial margin for non-centrally cleared derivatives, now is a good time to step back and reflect on the past implementation phases and to explore in more detail the issues faced by market participants who have or will in a future phase become subject to the requirements. This exercise is important in my view in order to understand whether there are actions that we as regulators can take to mitigate the potential compliance bottleneck caused by an unprecedented number of market participants coming into scope in the last implementation phases.

First, we will hear an update from the regulators. Mike Gibson from the Division of Supervision and Regulation at the Board of Governors of the Federal Reserve System will talk about actions regulators have taken with respect to the margin rules. In a timely development, several regulators voted on a joint notice of proposed rulemaking last week that would amend certain aspects of their swap margin rule. Mike will update us on those amendments. And then Rafael Martinez will update the group on the CFTC’s recent actions, including a staff advisory issued in July in support of the BCBS-IOSCO statement from earlier in the year, which clarified that documentation requirements for uncleared swaps would not apply until a firm exceeds the $50 million IM threshold with a particular swap dealer.

Next we will hear from buy-side market participants. Richard Grant from AQR Capital Management and Wendy Yun from Goldman Sachs Asset Management will discuss some of the challenges and the preparations their firms have undertaken to prepare for the upcoming implementation phases. Among the issues Richard and Wendy will touch on are those involving separately managed accounts, seeded investment funds, eligible collateral, and documentation.

The third panel on uncleared margin will feature Dominick Falco from BNY Mellon and Judson Baker from Northern Trust. The two panelists represent custodian banks tasked with holding initial margin for non-centrally cleared derivatives. They will discuss their experience engaging with market participants in the earlier phases of implementation and what they are doing to prepare for the unique challenges of later implementation phases. The custodian’s perspective is one that we don’t often hear here at the CFTC, and I am looking forward to learning more from Dominick and Judson on how they are managing the documentation and operational challenges.

Lastly, Tara Kruse from ISDA will present on some of the differences across jurisdictions that have evolved relative to regulatory implementation of uncleared margin rules. Jurisdictional differences in key areas, such as settlement timeframes and eligible collateral, present challenges for market participants.

After lunch, we will turn our focus to the cleared derivatives space and how regulation of global central counterparties has evolved. Specifically, Sean Downey from the CME Group, Carolyn Van den Daelen from ICE Clear Europe and Jackie Mesa from the FIA will present on the provisions of EMIR 2.2 that affect non-E.U.-based CCPs and ESMA's related draft technical advice and consultation reports. EMIR 2.2 materially changes the regulatory framework for non-E.U.-based CCPs, particularly when those CCPs are determined to be systemically important to the E.U. or one of its member states. I believe that it is important that we fully understand the proposed changes and how they might affect our own registered derivatives clearing organizations. Sean, Carolyn, and Jackie will present on the specifics of ESMA's consultation papers in tiering criteria and on comparable compliance, including their reactions to the ESMA's proposals.

I am looking forward to digging deeper into some of the topics we covered more generally in the April meeting. And I again want to recognize the tremendous amount of work and time that has gone into preparing for this meeting. Thank you, Andrée.

MS. GOLDSMITH: Chairman Tarbert?

CFTC CHAIRMAN TARBERT: Well, thank you very much, Commissioner Stump, for convening this meeting. Thank you to all of you for being here. I see many faces that I have known throughout my time here at the CFTC, all 60-plus days, as well as in my various former roles at the U.S. Treasury and even in the private sector prior to that. So it is great to have you all. Andrée, thank you so much for your work in making this possible.

We have got two big-ticket items today. Right? We have got margin requirements and the phase-in of phase 5. And this is really important because we are literally going from about 40 covered entities to over 700. And in that 700, we expect that we could see the operationalizing of about 7,000 initial margin relationships when we move to phase 5. So I think it is really important that we take the time to get it right, we understand the insights from our fellow regulators at the Fed as well as from all of you that are affected. I will note that the banking regulators on September 17th extended the compliance period for one year. I can tell everybody today that our staff has been working on a proposal to amend the corresponding deadline for our rules. And it is my hope that the Commission will vote in the near future on whether to issue the proposal.

Other big-ticket item obviously is EMIR 2.2. And I know this advisory committee has spoken to this issue in the past. And your views have been really important in helping us understand the issue better and working on the dialogue with our European counterparts. Obviously, CCPs are really important. Many of them are systemically important. And we fully understand that every financial system has to think about systemic risk that it faces, whether that risk comes from inside the system or potentially outside the system. I think our view is that at present, none of our CCPs in the United States, based in the United States, pose systemic risk outside the United States and certainly not to Europe. But, nonetheless, we understand the reasons why EMIR 2.2 has been brought to the fore to deal primarily with the Brexit situation. And what we want to do is make sure that we don’t end up in a place where we have, you know, again by inadvertent regulatory moves, market fragmentation, contradictory rules, and even potentially increases to systemic risk here in the United States.

So to that end, we have started the dialogue with the European Commission under my chairmanship as well as ESMA. We have had one very good meeting where we had the opportunity to talk more about deference to really truly understand their concerns. And so we are hopeful that over time, we will be able to address any concerns they have while also reaffirming the concerns that we have in getting to a place where we have got global cooperation. So we very much look forward to your views in that regard, ways that we can continue on that path to reach a mutually beneficial solution.

Thank you.

MS. GOLDSMITH: Commissioner Quintenz?

COMMISSIONER QUINTENZ: Thank you very much. And thank you, Commissioner Stump, for your leadership of the GMAC and for the important agenda today. Thank you, Andrée, for your hard work. And thank you, Angie, for your leadership as well.

Let me just quickly echo the comments of both Commissioner Stump and Chairman Tarbert. These are two very important issues. I think it makes a lot of sense to continue to discuss them publicly. The uncleared margin rules I think show the problems with using notional value. They show the problems when regulations are not calibrated to the risk and when cost-benefit analysis is inadequate.

Hopefully we will continue to move away from using notional value in regulatory rules that impose costs without relation to risk because I think we have been dealing with the negative impacts of those decisions for quite some time now. And I am very pleased that we are taking action to try to resolve some of them, but I think it is important that we also acknowledge that this should be the end of that type of consideration.

I am very grateful to the chairman, his leadership, and look forward to considering any action that the Commission can take to alleviate the burden and to provide more compliance time or to recalibrate those rules.

On EMIR 2.2, let me just say that I think we are all well-aware of the tiering proposals. And I think it is important to acknowledge that this is not an exercise in big data analytics, where thousands or millions of data points are run through some type of tiering or sorting algorithm to arrive at an unknown result. I believe it is impossible to develop this proposal and to calibrate this framework without knowing the results. Therefore, I think the earlier that we all receive clarity on what those results are, the more likely it is we can avoid very negative consequences and outcomes that have yet to be taken off the table.

So let me commend again the GMAC for addressing these very important issues. I look forward to hearing all of your thoughts. Thank you.

MS. GOLDSMITH: Commissioner Behnam?

COMMISSIONER BEHNAM: Good morning. Welcome, everyone. Good to see all of you. First off, thanks to Commissioner Stump, Andrée, and Angie, of course, for your leadership and Chairman and Commissioner Quintenz.

I will just reiterate what everyone said already, very important issues, look forward to hearing from everyone. And I do appreciate and acknowledge both Chairman Tarbert and Commissioner Stump’s leadership on these very important issues, a lot of very difficult questions to sort of unpack that have a lot of big consequences, so look forward to the committee’s deliberation and any recommendations and Commission action. Thank you.

MS. GOLDSMITH: And I will turn it over to Angie to get the agenda started.

CHAIRPERSON KARNA: Great. Thank you very much, Chairman, Commissioner Stump, Andrée, and the other commissioners. And thank you all for participating here today.

As you have heard, we have a very busy day. We are going to be digging into two very important issues. Your diverse perspectives are very welcome. And, as a logistic matter, just to remind you, after each panel presentation, there will be an opportunity for questions, comments, and other feedback. If you just put your card vertically, then I will know to call on you.

So, to start off, we are going to have our first panelist, Michael Gibson, who is the director of the Division of Supervision and Regulation for the Board of Governors of the Federal Reserve; and Rafael

Martinez, who is a senior financial risk analyst for the Division of Swap Dealer and Intermediary Oversight at the CFTC. And they are going to be providing a status update on the implementation of uncleared margin rules.

MR. GIBSON: Thanks for the opportunity to join your group today. I am Mike Gibson. I am from the Federal Reserve Board here in Washington, from bank supervision, but, more importantly for this group, I am also one of the two co-chairs of the international working group on margin requirements that has developed the uncleared margin standards that we are talking about today and has been monitoring their implementation over the past few years. It is a joint working group that is cosponsored by the Basel Committee on Banking Supervision and the International Organization of Securities Commissioners, IOSCO. So we have a broad representation on the group and I am happy to talk about some of the progress that has been made over the past few years.

Just to set the landscape, I would just remind everyone that as part of the post-financial crisis reform efforts under the auspices of the G20, there was an effort to improve the safety and security of derivatives markets. And probably the most important part of that effort was a shift of standardized derivatives into clearing. So, obviously, the CFTC has played a big part in that here in the U.S.

Another part of the G20 program on derivatives markets was to have margin requirements on uncleared derivatives. There were two basic reasons for that. The first was to make sure that the program to move standardized derivatives into clearinghouses, that the incentives were right. So if uncleared derivatives had much lower requirements, there might be an incentive to avoid clearing. And nobody wanted to see that happen given the benefits of clearing for financial stability. And then just generally recognizing that not all derivatives can be cleared, there was a recognition that uncleared derivatives needed the safety and security that margin requirements provide to reduce the overall systemic risk in the system and the interconnectedness from derivatives markets.

So, with those two objectives in mind, the international standards on uncleared margin were developed and have been implemented over the past few years. As has already been mentioned, we are coming up on phase 5 of the implementation. Phases 1, 2, 3, and 4 mostly involved larger firms, and phase 5 is when some of the smaller entities are going to come in scope for the margin requirements. Just to remind everyone what these requirements are, the requirements are that for uncleared derivatives, there is an expectation that variation margin should be exchanged and for entities that are above a threshold measured by exposure, that there would be an expectation that initial margin would be held as well. So the initial margin exposure threshold in the international standards is $50 million of exposure. So when we eventually finish with the implementation of these standards, there will be an expectation that entities with greater than $50 million of exposure, that there would be initial margin associated with those relationships.

Of course, it is important to note for the scope of coverage of these requirements that it only applies to financial entities. So commercial end-users are not scoped into these requirements.

The phase 5 that has already been mentioned is the final, what had been the final, phase of implementation. And the implementation had been staggered based on notional amounts of derivatives that counterparties held. So the first phase, second phase, third phase, fourth phase, there were cutoffs based on notional amounts of derivatives. And this fifth phase would be bringing in, as was already mentioned, hundreds of small financial end-users.

The international working group that I mentioned has been doing monitoring of progress on implementation. And last year, we had already started to hear from the industry counterparts about the challenges of bringing on board so many smaller entities in a relatively short period of time. I guess some people would say two years is a lot of time, but for all of the requirements and the number of entities involved, two years is not that much time to do this onboarding.

So a couple of things happened at the international level earlier this year to relieve the burden on the phase 5 implementation. The first is that the Basel Committee and IOSCO put out a statement earlier this year clarifying that for counterparties that are below the $50 million exposure threshold, that they would not have to have all of the trading documentations and custody arrangements that would be needed to post and secure initial margin until they are actually crossing the threshold, so the smaller entities. It was clarified that they would not need to have the trading documentation and custody arrangements in place until they actually crossed the threshold and fall in scope. And in that case, then, of course, they would be expected to have the arrangements in place. So that was the first effort out of the international working group earlier this year.

The second thing that the Basel Committee and IOSCO did earlier this year was to extend the phase-in period by one year, as was already mentioned in the introduction. So there is an additional phase. I guess it should be called phase 6, which will extend through September 2021 for the smaller financial end-users. Basically, it is splitting up the entities that would have come into scope in 2020 and split them up into 2 groups. So some will come in 2020. Some will come in 2021.

The U.S. Prudential Regulators are part of those discussions. And we supported those international changes. And, again, as has been already mentioned, the Prudential Regulators have developed a notice of proposed rulemaking that the FDIC acted on at their board meeting. So the notice of proposed rulemaking from the FDIC is out in the public domain, and you can read it on their website. The Federal Reserve Board has not acted yet. So I can’t speak for what the Federal Reserve Board would be voting on, but we are part of the Prudential Regulator group. So I will just give you a description, a brief description, of what the Prudential Regulators’ notice of proposed rulemaking has. And, again, this is based on what the FDIC has already put out into the public domain.

So the first two elements of the notice of proposed rulemaking from the Prudential Regulators are the two things that I already mentioned that came out of the international working group earlier this year, namely the clarification on documentation not being needed for the small entities below the exposure threshold and the additional phase-in into 2021.

There are three other elements that I would just briefly mention as part of the notice of proposed rulemaking. Two of these have to do with legacy swaps, and I just have to explain a little bit. Legacy swaps are those that were in place before these margin requirements came into effect. And the margin requirements are only applied to new trades. So existing trades aren't in scope for the requirements. And, of course, a lot of derivates trades are long dated, so there is an expectation that some of these legacy trades could last for a while.

The two clarifications that are part of the notice of proposed rulemaking, the first is that these legacy swaps can be amended to replace LIBOR and other similar interest rate benchmarks that, as everyone knows, are being phased out and may disappear in a couple of years. Those contracts need to be amended, and the notice of proposed rulemaking proposes that swaps can be amended to replace LIBOR without losing their legacy swap status.

And the second element related to legacy swaps is to clarify that so-called lifecycle events, like trade compressions, would also not cause a legacy swap to lose its legacy status.

The final element of the Prudential

Regulators' NPR that the FDIC released last week would be to remove the requirement in our rule that initial margin be collected from affiliates, although it would retain variation margin requirements for affiliates. This is consistent with the international standard, and, of course, there are other restrictions on affiliate transactions within bank holding companies I won't go into, but the inter-affiliate margin requirements that had been in the Prudential Regulators' rule were in addition to the existing requirements on bank holding companies, which would stay in place.

So I will stop there. And I look forward to answering your questions.

CHAIRPERSON KARNA: Mr. Martinez?

MR. MARTINEZ: Good morning. So I have been asked to provide the update on the implementation. And a lot of the updates actually coincide with actions taken by the Prudential Regulators. We may have sometimes a difference in terms of the ways we go about it. So we also have interim final rules, orders, no-action letters, and different ways. But, in general, the objective is to remain harmonized with them. And I think we have done quite a decent job of that. We have very frequent calls every week. And we have also not as frequent but with the other regulators around the world that are implementing these rules.

And so let me mention much of it is similar to or the same as what Mike had just described to you. I will mention some specifics of where the CFTC stands on that. With respect to the legacy status, so one big concern was that the rules apply prospectively, so for new swaps. Old swaps were exempt from the rule. But, then, in the U.S., any amendment to the swaps would bring in scope those swaps as they were amended. And we have discovered that, actually, there are specific situations in which it actually works contrary to what the intent of the rule is, which is to reduce the risk in the system.

So Mike mentioned about there is one situation very clear to everybody is the situation with Brexit in which it is clear that for no particular business decision of a lot of companies in Europe, they will have potentially to change the counterparty of some swaps to be able to service the clients. And so we want those swaps to be amended. And we don’t want the margin requirements to be an impediment to that. So we had an interim final rule at the CFTC in March 2019 to say that swaps that are transferred legally solely as the result of a no-deal Brexit -- it just was the case for a no-deal Brexit -- that any amendments that have to be made would not bring those swaps, those legacy swaps, into scope.

For LIBOR transition, as Mike mentioned, it is part of the prudential rule. CFTC staff, we need to harmonize with the Prudential Regulators, but we also have to coordinate with other divisions because for us, in the CFTC, LIBOR is not just a question of margin, but it also touches on legacy status for clearing, for customer protection, reporting, and several other rules. So we have to find this way of harmonizing both across divisions and with all the regulators. And so we are a bit of second movers on that, but we are actively preparing policy for this right now. And we expect to have something for review by the Commission in the very near future.

I should mention at CFTC, we are having very frequent meetings with the ARRC and the Alternative Reference Rates Committee to make sure that we have dialogue so that the relief that we offer is one that actually will be effective.

Next, also in May of 2019, the Division of Swap Dealer and Intermediary Oversight issued a no-action letter that provides relief to certain amendments to legacy swaps so that they don't lose their legacy status. They are all amendments that reduce the risk in the portfolios and so the material amendments, partial termination and novations, swaps that result from multilateral compression. So all of these are actions that reduce the risk in the portfolio. And we had the request for that for some time. And Tara knows exactly how long. It is in the months. But I think what really made this something we really needed to do was that it works with the LIBOR and the Brexit case because before amendments need to be made for Brexit or LIBOR, it is ideal that parties can compress and reduce the number of swaps that will have to be amended. So we are hoping that -- and so that is what really triggered issuing this in March. So it should be seen as part of the effort to facilitate LIBOR and Brexit.

On issues related to 2020, to the phase-in and the congestion that had been identified, so the CFTC issued, as mentioned by Commissioner Stump, in July an advisory codifying the guidance from the BCBS and IOSCO. So I guess since margin, initial margin, is only exchanged when the exposure is above a $50 million threshold. I think what we have tried to say is if you collect it, you protect it. But you don’t need to protect something you have not been collecting. And the protection requires a lot of paperwork and was cited as one of the biggest burdens on the industry for entities that may never exchange margin.

Now, that $50 million threshold -- to Commissioner Quintenz’s concern about the use of notional. And there is no doubt that notional is a very blunt measure of activity. This serves as a second step if the first step was a calculation of notional, which, by the way, we have a lot of people tell us they are having difficulty calculating notionals to decide if they are in scope or not. But then the second step helps to figure out which ones have the relationship that really needs to be margined by having that risk-based measure. It is not ideal, but it helps that after the notional decision of a minimum swaps activity to be in scope, we have this risk-based measure.

Also, they are facing extension. So, as the Chairman mentioned in his opening remarks, we have drafted, DSIO has drafted, a proposed rule to put in place this extension that some Prudential Regulators proposed last week and at the recommendation of BCBS and IOSCO. So we prepared that. And that should be soon circulating for your consideration.

Models for phase 5. One of the things, of the concerns, that has repeatedly come up is that developing models is a challenge for many of the phase 5 dealers. In addition to preapproval, the requirements to ensure that the model is performing adequately to continue monitoring of the model requires governance, extensive governance, efforts by the firms, such as periodic back testing, benchmarking, and external audits. And some have indicated they may use the simpler method of the GRID, but that, as we know, tends to impose some higher margin requirements than the model. So there are other people who have expressed interest in using a third-party vendor for that. However, that brings the issue of the monitoring and all of the governance. Whether it is a calculation that is done in-house or by a third party, the firm has to retain responsibility to make sure that that model produces numbers that protect the firm.

At this point, I want to mention that the National Futures Association, the NFA, with whom we have a lot of coordination -- we have also weekly calls, I think biweekly now but sometimes weekly as needed. They have been very active, reaching out to phase 5 dealers. In the U.S., the model requirements only go to the dealers, not to all of the parties that have to exchange margin. So that is a difference we have with rules in other places. This has allowed us to concentrate specifically on the dealers. And the NFA has been very active, has spoken with every dealer, has asked them about their plans, has tried to respond to all of their questions, and they have had webinars, several of them. And they have generally tried to facilitate the process. So I want to thank the NFA for the wonderful job they have been doing on that.

In terms of interaction with other rules -- so this is not something the CFTC or the Prudentials have done, but I need to mention it -- is that the SEC finalized the rule on margin requirements in June. And while there are significant differences with the WGMR-based standards, the commissions and staff at both agencies -- and thank you, Commissioner Quintenz, for your efforts on that -- they have endeavored to close gaps to facilitate for those entities that are subject to not just the SEC rules but other rules, including the CFTC. And, you know, of particular note is that for a standalone security-based swap dealer that is also a swap dealer that has below a certain level of activity, the SEC has allowed for compliance with their rules by compliance with the CFTC rules. So a kind of substituted compliance with us. And I think that was just -- that is one of many, many changes that the -- to the proposed rule by the SEC that does facilitate compliance for dual registrants.

Then also I want to mention in terms of substituted compliance internationally, the CFTC has responded to requests for substituted compliance from major swap jurisdictions. So you will see that. And we think that is a major tool to ease compliance for many, many entities.

We currently are working a comparability determination for the U.K. in the event of Brexit, just specific to the U.K. And we have I think responded to almost every request that has come from any major jurisdiction. And there are some that we haven't received a request yet. So it is hard for us to act. But we have reacted to that. And I want to thank Frank Fisanich, our chief counsel in DSIO, for that.

Now, industry and the public have brought forth many, many other issues, some of which will be mentioned later today. Since we don't have anything imminent or that we have done on that, I won't discuss them, but I look forward to those being brought in the presentation later today because this is an excellent, this committee is an excellent touch point for staff to listen and develop further understanding. And thank you.

CHAIRPERSON KARNA: Thank you, Mr. Gibson and Mr. Martinez.

In order to allow staff to listen and develop further understanding, I would like to just open up the floor with a broad question. We heard a lot about the notice of proposed rulemaking from Mr. Gibson and similar initiatives that the CFTC has been engaged in since we last met. I am wondering if people can give their perspectives on whether that notice of proposed rulemaking goes far enough in addressing the challenges faced with respect to the margin requirements that we are talking about today. Any additional suggestions for the regulators on what they could do with respect to margin rules?

(No response.)

CHAIRPERSON KARNA: Apparently you have done an excellent job.

(Laughter.)

CHAIRPERSON KARNA: Mr. Cisewski?

MR. CISEWSKI: So I have a couple of questions if you don't mind. The FDIC and the OCC's proposal, one element of that proposal would eliminate initial margin for inter-affiliate transactions. Is that right?

MR. GIBSON: (Nodding head.)

MR. CISEWSKI: I wonder if you could just for the public and for the record, so to speak, explain the purpose of inter-affiliate derivatives transactions? And then I will have a couple of follow-up questions.

MR. GIBSON: Sure. So within a consolidated group, there is going to be many legal entities. And different legal entities are facing different customers. So within the group, there is often transactions among affiliates that are redistributing the risk around the groups, sometimes so it can be centrally managed in one place, sometimes because a customer wants to face a legal entity in a particular jurisdiction and the firm might prefer to have the risk managed out of, you know, London or New York, for example. So there is a variety of, usually a variety of, reasons why that might happen.

MR. CISEWSKI: So it is quite literally transferring risk between legal entities within a corporate group, right? And the risk management entity could be an entity in the United States, and it could be a bank, for example, with depositors or it could be some other type of regulated entity in the United States with customer funds.

MR. GIBSON: (Nodding head.)

MR. CISEWSKI: That is a yes?

MR. GIBSON: Yes.

MR. CISEWSKI: And we will continue to impose under the proposal variation margin requirements. Is that right?

MR. GIBSON: (Nodding head.)

MR. CISEWSKI: And those would account for market risk for the transactions?

MR. GIBSON: Mark-to-market, yes.

MR. CISEWSKI: And the required IM that would be required today, that would account for other types of risks. Could you explain what those risks are in the event of a default of the affiliate, for example?

MR. GIBSON: Sure. So the initial margin is a protection, as you said, against default of a counterparty. So the variation margin would protect against mark-to-market changes from day to day. And the initial margin is extra protection, whatever happens between the time when the entity stops meeting its variation margin and the actual default occurs and the defaulted exposure is then crystallized, I guess you would say. So because the defaults don't happen instantaneously, the initial margin is a protection against the price moves that might happen over that, you know, pre-default period.

MR. CISEWSKI: And that is modeled using certain assumptions and specifications --

MR. GIBSON: Yes.

MR. CISEWSKI: -- specific to the portfolio of the affiliate. Is that right?

MR. GIBSON: Right. So for the initial margin requirements under the international standards, you are allowed the option of using a model that has been approved by your regulator or you can use a standardized GRID that has simpler calculations that are just based on the type of the derivative, for example.

MR. CISEWSKI: And so margin period of risk, can we talk about that? Could you explain the concept and how that relates to initial margin and the potential exposure calculation, for example?

MR. GIBSON: Sure. So margin period of risk is the time period that I was just talking about where it is the time period right before the counterparty defaults, where maybe they have stopped making their variation margin payments because they are on their way to defaulting. And over some time period, the counterparty, the non-defaulting counterparty, is going to be exposed to the risk of market moves. So that is what is meant by the margin period of risk.

MR. CISEWSKI: And the assumption currently for an inter-affiliate transaction within a bank holding company that would move risk, let’s say, from a foreign affiliate to a U.S. bank, what is the margin period of risk that we would apply to those inter-affiliate transactions?

MR. GIBSON: I don’t know. I don’t know the answer to that question. I am sure there are some.

MR. CISEWSKI: Do you know by chance, Rafael?

MR. MARTINEZ: So what is a margin period of risk that they would do without requirements that --

MR. CISEWSKI: For initial margin imposed on inter-affiliate transactions.

MR. MARTINEZ: Where there is no requirement you mean, no requirement from these rules because in these rules, I believe, at least on CFTC rule for inter-affiliate margins with certain entities, there is some, not all -- the CFTC has requirements with broad exceptions for inter-affiliate transactions. Those that don’t fall into one of these exemptions, they have a five-day margin period of risk.

MR. CISEWSKI: A five-day? So the assumption is essentially that in the event of the affiliate defaulting within five days, you should be able to hedge out your risk and/or liquidate positions in a way that mitigates the risk to the risk management entity. Is that right?

MR. MARTINEZ: Well, that is what the requirement is. The assumption that you take exactly that amount would depend, of course, on the subs.

MR. CISEWSKI: Right. So that is a five-day period right now for some transactions, but that is a sort of uniform rule for some complex portfolios between affiliates. It could actually take longer, in which case there would be some residual risks. For some other portfolios, it might take one or two days. You could very easily manage your risks there. So how did you arrive at the five-day period or what was the thinking, just in a nutshell?

MR. MARTINEZ: Well, the 10-day period of risk was sort of the starting point, so because that is used and had been used for many, many years as for the calculation, for capital calculations. And so those are things that are already used by entities in their calculation for capital. And we didn’t want to have multiple numbers floating around or burden further the development of systems.

For inter-affiliate, we thought that it was appropriate to have a shorter period of risk because inter-affiliates have a better sense. When a counterparty defaults, many times, it is a bit of a could guess our price for the counterparty. Right? So we might get that from your affiliate, you have a better sense of what the state would be of an affiliate. And we also thought that the company itself, operationally it would be easier to protect themselves from a default than when it is a nonaffiliated counterparty.

MR. CISEWSKI: Right. So you were trying to come up with a rule that was tractable, but there could be portfolios that are especially complex where there is some residual risk at the risk management entity. There could be portfolios where that is more than adequate. Is that right?

MR. MARTINEZ: That is correct. There is always that tradeoff when you write the rule -- right? -- in which you are trying to find something that can be complied with by all the entities that are going to be subject to that rule. It is also something that is going to be easier for your examiners to evaluate. And so it is easy to understand, easy to apply, and roughly right or at least not grossly wrong, though, of course, you know, the same happens with the speed limits or anything like that, right?

MR. CISEWSKI: So the purpose for an inter-affiliate transaction is to move risk around the corporate group. The risk could be moved to the United States. And it could be moved to a bank entity, for example. And there are certain assumptions about what that initial margin requirement will be. Those assumptions for many portfolios may sort of adequately account for the potential exposure. And in other cases, we just acknowledged it may not actually account for that. And now we are proposing to eliminate required initial margin altogether. So how do we look at managing potential exposure in the absence of a required initial margin for, for example, a U.S. bank entity?

MR. GIBSON: So with respect to U.S. bank holding companies, there is a lot of transactions among affiliates because they are global groups and they have lots of legal entities. So there is existing protections and regulations in place on affiliate transactions and affiliate exposures that provide some safeguards. So those are still in place and aren’t being changed.

MR. CISEWSKI: So, for example, Reg W?

MR. GIBSON: Yes.

MR. CISEWSKI: Is that what you are referring to?

MR. GIBSON: Yes.

MR. CISEWSKI: Okay. And Reg W would apply to transactions between certain affiliates but not all, right? So if it is a transaction between bank chain entities, Reg W would not apply initial margin requirements, for example, to that transaction between a bank chain entity?

MR. GIBSON: I am not sure what bank chain entity is, but, generally, Reg W applies to protect the depository institution.

MR. CISEWSKI: So in the case of a bank chain entity, my understanding is -- and perhaps Mr. Yamada or Mr. Klein can weigh in on this but that Reg W requirements would not apply. And, in any event, it would require an arm’s-length transaction that would not necessarily impose required initial margin, at least at the level that would be required under the regulations currently.

So my only point in all of this is to say that by eliminating initial margin requirements under the prudential proposal for some of the prudentials, I should say, we actually are allowing risk to come back to the United States quite directly to regulated entities that have customer funds at risk or depositor money at risk. And that poses a number of concerns, not only for financial stability but also in terms of whether the FDIC and the OCC, which have the primary mandate of protecting, for example, a national bank or, you know, a bank with -- or other type of bank in the United States, specifically to that legal entity, that they are actually allowing risk to come into that entity, which is quite puzzling.

CHAIRPERSON KARNA: Mr. Klein, do you have some feedback?

MR. KLEIN: I just wanted to go back to some comments that Michael made when he introduced the rule proposal and described the rationale behind eliminating the inter-affiliate initial margin requirement. And I think we talk not about transferring risk but about managing risk. And I think that is one of the primary concerns that imposing initial margin requirements can distort internally the ability to manage risk centrally by not moving risk around but by distributing risk in a way that makes it easier for the entity to manage that risk and to reduce the risk, not to put the risk someplace else. And I think it is important to keep that in mind.

I also would hearken back to Michael's comments about the existing rule 23A and 23B requirements in Reg W that do impose very substantial restrictions on the ability within a bank holding company to engage in certain transactions with the deposit-taking institution and its immediate affiliates and, in fact, require collateralization of many of those transactions. So, again, there is an existing protective mechanism, particularly designed to protect the deposit-taking institutions, and a desire among bank holding companies to be able to put risk in a place where they can visualize it, manage it, and reduce it.

CHAIRPERSON KARNA: Thank you.

Mr. Colby?

MR. COLBY: Hi. Jim Colby. I am the treasurer of Honeywell. I also represent the Coalition for Derivatives End-Users.

You were asking about why companies use inter-affiliate trades. The primary reason companies use inter-affiliate transactions and just using our company as an example -- we have 1,000 legal entities around the world that have risks that we try to manage. If each of those entities independently hedge those exposures, many of which are offsetting, it is very inefficient. We would have unnecessary documentation requirements. We would be using more bank credit lines than we really need. And we would have people engaging in derivative transactions that really don't understand how to risk-manage those transactions as much as we do at the head office.

So what we do is we calculate the businesses. All the different businesses around the world report their exposures in to us. We centralize them. We net them down by risk category and hedge the net risk externally with a bank. And so what this allows us to do is to dramatically reduce the amount of external-facing derivatives transactions that we execute with the street. And it allows us to make sure that we have proper people entering into derivatives transactions and controlling those transactions to make sure that we are doing it properly, dramatically lowers the amount of credit exposure that Honeywell has with our external counterparties.

Those credit lines cost money. And if we had to post -- and if our bank counterparties were required to post initial margin, both on inter-affiliate transactions and on external transactions with the counterparties they hedge with, that is duplicative initial margin requirements on the same transaction. That increased cost, those costs are going to be passed on to us as end-users, making it more costly for us to hedge risk.

It should be pointed out that most inter-affiliate transactions if the affiliate transacts with the centralized treasury unit, which transacts with the street or a bank counterparty, that end-user that has the original exposure also has an underlying exposure on the other side. So they are not taking naked risks. They have a risk with their customers or with their suppliers. They hedge it with the centralized treasury unit. So they are hedged. Centralized treasury unit has a transaction with their international affiliate. And then they hedge it with a bank. So they are hedged. So it is a very efficient way of managing risk.

And I think that, you know, if you are talking about imposing duplicative initial margin requirements across a legal entity structure, that is extremely inefficient. And I think it will reduce hedging activities. It imposes costs that overweigh any risk management objective that you are trying to achieve.

CHAIRPERSON KARNA: Thank you.

Ms. Bradbury?

MS. BRADBURY: Yes. I just want to switch gears a little bit. And you asked this question of if we are sort of perfectly satisfied with how all of the initial margin rules are going to roll out. And that is kind of the central thesis of today’s discussion. I don’t want to go through all of the things that Wendy and Richard are going to highlight in the next section as well as the custodians, but I think from our perspective as an investment management firm, it is not just the sheer numbers that are going from 40 to, you know, hundreds, but we are really different. We are not banks. And our businesses are organized differently. You know, in my firm, we manage funds that have, you know, comingled for different investors. We manage separately managed accounts. You know, just literally our business models are different. And so what I am very encouraged is that the Commission and other regulators are willing to listen to us about these practical implementation issues.

We are not trying to get out of the initial margin regime. Actually, firms like ours, you know, who manage a number of hedge funds, we have been posting initial margin for a very long time. So, you know, come on in. The water is fine, but I think there are very different specific issues. And what would be great is if they could get addressed before the rules hit.

You know, it is very striking to think of the FDIC putting out the inter-affiliate margin thing after banks have posted $40 billion of inter-affiliate margin. Right?

So I don’t know what the right or wrong answer is. I will stay out of that. I am not a bank. But it is great that you are actually looking at these things before the rules will hit most investment firms and other non-dealer entities. And we really appreciate that, that attention.

And I would encourage you. I have read both, you know, Richard and Wendy’s remarks. And they have a lot of just really practical issues that we need advice on and we may need rule changes on as well as a little more global harmonization, how you invest the collateral. They are just sort of things where the rules interact with our fiduciary duties and our investment objectives for our underlying investors. So thank you.

CHAIRPERSON KARNA: I am sensitive to time. So, Ms. Belich, I am going to give you the last question in the room, comment in the room. And then we will shift to the buy-side panel after we check some phones.

MS. BELICH: Great. Thank you. I will be very quick.

Same as Darcy, just not to take away from the discussion we are going to have later, but as a prudentially regulated bank, I think the additional kind of items that we would be seeking clarity on again I think that will be discussed later are, you know, being a dealer’s responsibility to kind of monitor and look at what these calculations are for the documentation relief, part specifically of the rule. What does that look like for us? And what are the expectations? You know, are we looking at this daily? Are we looking at this at other types of frequencies? You know, from the Prudential Regulators’ perspective, what is effective risk management in that area for a swap entity and banks?

And, then, just to kind of brush on what we were talking about earlier with the inter-affiliate, you know, of course, just to kind of reiterate that, you know, there have been inter-affiliate exemptions that we have seen the Commission offer in other parts of the rule that have covered on that effective risk management portion and that have worked well for banks and haven’t created any additional systemic risk.

CHAIRPERSON KARNA: Thanks.

Before we switch to the next panel, do we have any comments or questions from the phone?

(No response.)

CHAIRPERSON KARNA: Wonderful. Thank you very much, Mr. Gibson and Mr. Martinez. And I welcome the second panel.

(Pause.)

CHAIRPERSON KARNA: Great. So now we are going to switch to our second panel. And, as was highlighted at the end of our last panel, we are going to focus on practical implementation issues, specifically the buy-side's perspective on uncleared margin rules. Our presenters to start us off are Richard Grant, who is the global head of regulatory and government affairs, the associate general counsel of AQR Capital Management; and Wendy Yun, managing director and associate general counsel, Goldman Sachs Asset Management. Please go ahead.

MR. GRANT: Great. Thanks, Angie. And thank you, Commissioner Stump, for sponsoring this committee and the rest of the Commission for your engagement on the issues.

I have been asked today to represent the Managed Funds Association and share buy-side perspective on implementing regulatory initial margin, grateful for the opportunity and want to start by conveying our appreciation to the CFTC for your leadership responding to industry concerns on this topic, which include former Chairman Giancarlo’s letter to Vice Chair Quarles and the interpretive guidance from former DSIO Director Kulkin. I thought that the committee might benefit from an inside look at what we are doing at AQR to come into compliance with regulatory IM requirements. I hope this will give you a better sense of the heavy lift the regulation requires for individual buy-side entities as well as some concrete examples of the complexities we are working through.

At AQR, we manage a number of different types of accounts that will be subject to regulatory initial margin, including both individual and multimanager. Given the far-reaching scope of Reg IM, we formed an internal working group over two years in advance of the relevant deadline.

The project touches on a number of different aspects of the firm. And our group includes representatives from eight different entities or offices within the firm: legal to analyze rules and negotiate documents; our operations team to develop internal systems and processes for the transfer and tracking of daily margin calls; our engineering team to create a program for calculating and tracking AANA in multiple jurisdictions; our counterparty risk team for SIMM vendor selection and determining the scope of acceptable collateral from dealers; portfolio finance to work through the SIMM calculation and methodology and analyze the Reg IM impact on free cash and the investment of initial margin; our compliance team to develop and test policies, procedures, and reporting required in certain jurisdictions; our portfolio implementation team to analyze the cost and impacts of OTC instruments subject to the rules; and, finally, our trading team to determine the optimal instruments to use under the new regime based on market response and pricing. Now, this group is currently working through a series of key milestones for implementing the rule, which cover many of the topics I just mentioned, including other items, like securing custodial relationships, client communication and education, counterparty testing, and the overall cash management process.

As with any project of this scope, a number of challenges have arisen each step along the way. The challenges are not insurmountable for buy-side firms, but I hope that hearing them will provide you with some detail and color on the process we are going through and also context for why buy-side firms continue to seek assistance from regulators to ease some of the burdens.

So a few of the specific challenges I will highlight today are the AANA calculation. And although the calculation itself seems fairly straightforward, the global nature of the initial margin regime adds complexity to the building of a system to compute and track the calculation because it must account for jurisdictional differences related to product scope, calculation methodology, and the calculation timeframe; also SIMM vendors. Now, calculating daily margin will be facilitated for many of us by third party SIMM vendors, but outsourcing that process creates its own challenges.

We at AQR have met with a number of the vendors. And many of them do not yet have the capabilities to handle all of the products required for in-scope accounts. That limits our ability to effectively test these systems.

Operational challenges. A significant amount of effort is required to build the pipes necessary to implement the rules. For example, selecting a SIMM vendor is really only the first step in the developing of the capabilities to calculate and transfer initial margin.

Next, we have to build a system to convey the relevant portfolio positions to the SIMM vendor and then receive back the resulting SIMM calculation. That number must then feed into another new system that compares it to the dealer-provided initial margin number to confirm the final amount that is owed.

Next, a file containing the final margin number must feed into the firm’s existing system for calculating and transferring margin so that a wire transfer for the ultimate regulatory IM can be executed. As you can imagine, the technology and systems integration challenges related to this process are extremely time- and resource-intensive.

Finally, legal agreements. Legal

documentation challenges associated with the rule are frequently discussed as a headache. At AQR, we already have tri-party agreements in place to post negotiated initial margin with custodians. Yet, for each in-scope account, we will need to negotiate new tri-party agreements with each dealer counterparty for posting our regulatory IM along with separate tri-party agreements for the initial margin posted by those dealers.

Now, in addition to these tri-party agreements, we will also need to negotiate ISDAs and CSAs with each counterparty to govern regulatory IM. Each of these time-sensitive negotiations will stretch the bandwidth of even the most sophisticated buy-side firms' custodians and dealers.

Now, given these numerous challenges, what is our takeaway? It seems obvious, but I think we must acknowledge that we are likely to see a rush near the final deadline, even the extended deadline, as the full universe of in-scope accounts seek to comply. And this could put a significant strain on the industry. This rush will not solely be due to the relative preparedness of buy-side firms. Many of the challenges with regulatory initial margin relate to other parties in the system, be they SIMM vendors, dealer counterparties, or custodians. And each of these entities will need to make their own judgments calls about where to deploy their resources for Reg IM onboarding. So there is a very real chance that some buy-side firms will see their implementation delayed, despite their best efforts to plan ahead.

Now, the question before this committee is what regulators can do about the situation. While many of the challenges I just mentioned might arise with any project of this magnitude and cannot be solved by the regulatory community, we believe that any action regulators take to ease the overall burden on industry will pay huge dividends by allowing resources to be focused on the most important aspects of the new regime. To that end, the initial margin phase in threshold recently introduced was a very positive development. And I would also point to comment letters by MFA and other industry groups that provide helpful suggestions.

However, the one regulatory action I want to discuss today is resolving the current mismatch between the treatment of physically settled FX swaps and forwards in the AANA and initial margin calculations. Forcing these products to be included in the AANA calculation, even though they don't require initial margin, places an undue burden on firms and the financial system as a whole without a clear regulatory benefit. An example might be helpful on the point.

Take a managed futures fund with large FX and futures positions. That fund would generally prefer to use futures contracts, rather than swaps, to gain exposure in a given country. However, if the desired exposure relates to a futures contract that is not approved by the CFTC, such as SMI, the Swiss Market Index, then the fund would use a swap. In that scenario, a fund may exceed the $8 billion AANA threshold and become in scope under regulatory initial margin, almost entirely because of its physically settled FX positions. Yet, it is extremely unlikely that it would ever post initial margin given its small OTC swaps exposure and the $50 million IM threshold.

Despite recent guidance on systems and documentation needs for funds that are unlikely to exceed the $50 million margin threshold, as an in-scope fund, it would still need to be included in systems that track the AANA calculation and monitor the initial margin against a threshold. This type of incremental burden for a single fund is magnified when extended throughout the global financial system. By adjusting the mismatch for physically settled FX swaps and forwards, regulators could free up resources for industry to use on entities with much more meaningful OTC swaps exposures that are the real focus of the rule.

With that, I thank you for the opportunity to share our experiences. And I will turn it over to Wendy for her perspective.

MS. YUN: Great. Thanks, Richard. Thank you, Commissioner Stump, for hosting today’s meeting and for your focus on this important issue for us. I also thank the chairman and other fellow commissioners as well as the members of the GMAC Committee for the opportunity today to discuss some of the outstanding issues that asset managers and our end-user clients continue to face in implementing the later phases of the mandatory initial margin rules.

First, please note that the views I have expressed today are my own and those representing the SIFMA Asset Management Group, or AMG, and not of my firm. We also fully commend and support the actions taken by BCBS-IOSCO, the June 23rd statement, and the recent Prudential Regulators' proposal to extend the implementation periods and splitting phase 5 essentially into 2 separate phases and adopting a $50 billion AANA threshold for 2020. We would also support the March 5th BCBS-IOSCO statement as reflected in the CFTC advisory 1916 and the Prudential Regulators' proposal to also not require documentation, operational or custodial setups unless the initial margin does exceed the 50 million IM threshold.

We would strongly encourage, though, that global regulators adopt both standards so that we can achieve much needed regulatory consistency and clarity across jurisdictional requirements. Absent such, it will cause a lot more disruption and uncertainty in how to implement the rules in the final stages for many of us. While those actions would provide some much needed time for us to get ready for the last two phases, I think it is important to highlight that that by itself will not solve for some of the scoping and implementation challenges that we as asset managers and our end-user clients are confronted with.

By way of background, many of us manage money for a wide variety of different types of clients, whether it be corporates, you know, sovereigns, large pension funds, you know, central banks and other types of entities, each of which we typically are hired by that client to employ a specific investment strategy. Many clients do hire multiple asset managers because they want to, one, diversify their investment portfolio; and, two, take advantage of the expertise that that particular manager has in a particular mandate or strategy; and, three, to diversify any kind of concentration risk they would have to any one of them.

In these types of arrangements, many of us set up our own trading agreements for our clients. And we have no transparency nor control into the trading activity of our clients outside of our mandates. As a result of this practice, it makes it quite challenging for us to implement some of the key features of the UMR rules, more specifically in relation to the AANA calculation, the sharing of the 50 million IM threshold, and MTAs. You know, these parts of the rules require us to have concerted efforts to collect data on an aggregate basis. And, unfortunately, in many cases, the burden, you know, lies with our clients. Our clients are the ones who then have to collate and aggregate the information, not only for their own asset managers across the different trading mandates that they employ but also of any kind of consolidated affiliates that they are also consolidated with from a financial statements perspective.

Some clients have already highlighted that they will not be able to get the information from some of their affiliates because they don’t have any type of transparency or relationships with those affiliates to gain knowledge of the information. Other clients have expressed concerns and we, too, have concerns about how they will calculate the AANA amount. Some of us already reached out to clients and asked them to confirm whether or not they exceed the AANA threshold. Unfortunately, some have gone out earlier and asked about the 8 billion. Others have asked about the 50 billion. Some have asked about both. And it has also been a mixed bag in terms of how much detail, how much information you are collecting from those clients. Some have gone out and asked clients to just highlight if they exceed a general number, like five billion or six billion, and to come back to the asset manager to the extent they do so that the asset manager can work with those clients more closely to refine their calculations and determine whether or not they truly do exceed the AANA threshold amounts. Others have gone out with more specificity and asked clients to calculate the AANA amounts across different jurisdictions, whether it be March, April, May, June, July, and August, across different types of asset classes or, you know, different types of products.

As you know, in the different jurisdictions, there are different requirements. Some instruments are in scope in some jurisdictions. Some are not. So the inclusion of equity options, potentially TBAs, the definition of FXforwards or spots, those all differ from jurisdiction to jurisdiction. So it becomes quite challenging to give a client guidance as to the specific calculation that they must do in order to give you the accurate information per jurisdiction for you to then get the aggregate number.

As a result of all of this, we do see that there is likely to be delays in the implementation and the response feedback from our clients with their AANA information, which puts more pressure on asset managers in the buy-side in terms of the implementation once you get confirmation if the client does exceed the AANA threshold amounts. By virtue of having to wait for that confirmation because the asset managers and the dealers with whom we trade do not have the transparency as to the clients' overall trading activity. That means we have to wait and see whether or not the clients come back to us with confirmation that they are over the amount and then immediately start working with the dealers to determine whether or not we also exceed the 50 million IM threshold.

While we appreciate the time and the confirmation from many of the regulators that we don't have to employ documentation and the operational readiness in order to comply until we exceed the 50 million, again, that is a number that we are not in control of. And we don't have any transparency as to when the client may see that number with a dealer and its affiliates. All we can see is the trading activity that we carry out in our own portfolios for our clients. And so at any given time, the dealer may call us and tell us that now the client is in scope, either because they have crossed the internal threshold set by that dealer or the 50 million in the aggregate.

This poses a lot of concerns for us because now without any notice, we will have to scramble to try to get resources focused on getting ready with that particular dealer for that particular client. And, unfortunately, as asset managers, we do not hold the assets of our clients. We cannot choose their custodians because we don’t have the authority and the investment management agreement for us to do so. We would need to potentially amend our IMAs to give us the authority to actually select their tri-party custodian. We would also then potentially have to think about other issues, such as, you know, the regulations that apply to some of our clients, like mutual funds and European-regulated funds, whereby the custodian must be a qualified custodian or meet certain regulatory requirements. They may have to enter into subdelegation of strict liability requirements for funds subject to AIFMD in terms of the third party custodian holding assets of the fund pledged to the swap counterparties.

So, for those reasons, we typically will work with a client’s individual custodian, rather than ourselves picking a single one and setting up all of the necessary trading agreements and account control agreements for the tri-party segregation of the initial margin. This means that there are a lot more third party custodians that may not have been involved in the first initial phases that are now going to be tapped on the shoulder and have to get prepared for the documentation requirements in the latter phases. In many cases, it takes anywhere from six months to a year to negotiate the tri-party IM segregation agreements. And we are concerned about the readiness of some of the smaller custodians, who may not have experience in the earlier phases to be able to prepare for this requirement.

The additional issue is that we all will be, you know, trying to go through the same pipeline getting the attention of the dealers and the custodians to prepare for the necessary documentation and operational setups. Again, we will go through the same pipeline. We will be asking for the same attention from the same resources.

Dealers may choose in some instances based on the trading activity of the particular asset manager to put some on the sidelines or to halt trading with some of us based upon our trading activity versus some of the other peers that might have larger trading books with them. So that could be a potential disruption not only to the deployment of our trading mandate but just in terms of the client's performance under our assets under management. So that is something that we are very concerned about.

Once you get the AANA information, as we mentioned, the focus then turns to the IM threshold and the sharing of that amount. Right now, at any given time, the dealer must now perform two separate calculations on a daily basis: the initial margin requirement in relation to their existing book as well as what is the simulated initial margin that would be required under whichever model that they are using for initial margin and to determine whether or not that amount exceeds 50 million. So that is a daily requirement, maybe having to be done on a dynamic basis across all affiliates trading with that client and its affiliates. So you could see how much of a burden that will be as well as the, you know, potential surprise when clients come close to that 50 million.

So one of the proposals that we have highlighted in the SIFMA AMG letter is to potentially consider having the initial margin be calculated on an annualized basis during the same relevant AANA periods that currently exist under the rules, whether it be March, April, May, or June, July, and August. We feel that this would be an opportunity for the regulators to be and the dealers to be able to focus only on those types of accounts that really truly present any type of systemic risk. And it would also narrow the number of clients that we would be waiting to hear back from in relation to potentially exceeding the $8 billion figure. So it would mitigate and alleviate the dependency and the latency in relation to getting the client feedback in relation to their AANA calculation as well as allowing people to really focus on those portfolios that really truly are close to the $50 million thresholds. So that was something that we would ask the regulators to consider and happy to take any more questions about that proposal.

In relation to other types of issues that we are confronted with include seeded funds. Many of us have had seeded funds have to go early because of the consolidation requirements under the CFTC rules and Prudential Regulators' rules. And, unfortunately, in those instances, trying to set up all of the necessary documentation and trying to get the resources and the attention of our dealer counterparties has been quite challenging in the earlier phases. In some instances, we have only been limited to less than a handful of counterparties in meeting the regulatory deadlines, which causes other issues for fiduciary asset managers, such as, you know, achieving best execution, mitigating counterparty risk and meeting counterparty exposure limits under different jurisdictional requirements, and just overall risk mitigation and concentration of that risk in the hands of a few dealer counterparties.

We would urge the CFTC and Prudential Regulators to consider potentially not requiring the seeded funds to be consolidated. Again, it is a passive investment by a sponsor firm, many of which do not act in concert and have no transparency or control into the trading activity of the actual seeded funds.

I'd also note that in Europe, the rules under EMIR do not require E.U.-regulated funds to have to consolidate. And in some instances, in relation to some of the SICAVs and UCITS funds that also have been seeded, some asset managers have intentionally made sure to only limit the trading of those funds with European dealers in order to take advantage of that ability to deconsolidate. So, thus, you might see a bifurcation of liquidity in the market and also some regulatory arbitrage as people take advantage of those deconsolidation abilities under other rules. In both instances, we would encourage global regulators to not require seeded funds to consolidate in general and in Europe to not just limit this only to the European-regulated funds but for all seeded funds.

The other issue that we would like to highlight is in relation to the types of collateral that are permitted. In many cases, as a CFTC study has highlighted, you know, in the past, you know, most asset managers and their end-user clients have used cash as collateral. I think the CFTC study had shown over 77 percent use it for variation margin. This is because that it is the easiest form of collateral to transfer. There are no margin haircuts on it. You avoid settlement issues. You don’t need traders or other employees buying and selling, you know, different types of noncash collateral, such as Treasuries, dealing with odd lot sizes or settlement issues. And this is extremely important as, you know, the timeframes and compression for margin transfer timing has continued to condense. So for us, the ability to be able to use cash as an eligible form of collateral and take advantage of the services of many custodians in sweeping that cash into money market funds and pledging that as collateral is something that we would like to continue to be honored.

Under the CFTC rules and Prudential Regulators’ rules, there are some limitations to the use of money market funds, such as the ability of those money market funds to engage in repos and securities lending-type transactions. We feel that those types of limitations are burdensome and unwarranted. If you look at other CFTC rules, such as in relation to the regulation 1.25, for any type of money market funds that are government-only, there is no limit on the use of those types of money market funds as reinvestment, for reinvestment purposes of customer margin. So we would ask that there is similar consistency in relation to the treatment of money market funds under these regulations.

In Europe, even though there is also recognition of money market funds, there are also similar limitations in relation to their use. Again, we would ask the global regulators to examine these limitations and whether or not they should be removed so that we can continue the practice of using them. It helps us not only mitigate our exposures to the custodian banks, but also it helps us to be able to meet the necessary transfer timing and the ability to continue to use cash and avoid the settlement issues that we would face with transferring noncash collateral.

The last thing I would highlight is in relation to FX. As Richard highlighted, the inclusion of FX means that there is probably 30 percent more of clients in scope for phases 5 and 6 than are warranted. Many of them will not exceed the $50 million IM threshold.

And also, as Commissioner Quintenz had noted earlier, the use of notional as a blunt instrument in measuring risk here is somewhat punitive because in the case of FX, many times people will offset their risk in their books by entering into offsetting transactions. This means you have two directional trades, both of which will count from a notional perspective towards your AANA calculation, even though despite your risk portfolio is essentially flat. So we would ask that you reconsider and take a look at whether or not FX should be excluded from the AANA calculations on a go-forward basis.

The last thing I would mention, too, is in relation to the models. In relation to what Rafael Martinez had highlighted earlier, some jurisdictions require us to use models and do the back testing. Already it is a challenge for us from an operational perspective. Right now, we are having conversations with our dealer counterparties, not only to determine what regulations they are applying, whether or not they are using in some cases EMIR versus Dodd Frank rules because many dealers are subject to multiple jurisdictional requirements based on their trading activity but also different models that they may be employing for different asset classes. For us to be effectively able to manage and to check the margin requirements, we need to know whether or not dealers are using the SIMM calculator, the GRID, or their own proprietary models. And then we have to decide whether or not it is worth it for us to build out our margin models or to use vendors to be able to replicate so that we don’t have any breaks when exchanging margin with those particular dealers.

In some instances, I am afraid that, you know, for some end-user clients, the cost may be too heavy and too much to be able to support and justify the use of derivatives. They may be an elimination of certain counterparties based upon the fact that they have different jurisdictional requirements, it is too complex or complicated, or it may take too many resources to dive into their rules and their requirements and absent substituted compliance or deference by the global regulators, we may have no choice but to potentially turn off some of those trading lines unless we want to do the actual work, you know, to be able to comply with their other jurisdictional requirements.

I will stop there for any questions that the panel may have.

CHAIRPERSON KARNA: Thank you, Ms. Yun and Mr. Grant, for your very detailed presentation of both some of the challenges that you are facing on the buy-side as well as some proposed actions, which I am sure the regulators in the room are very appreciative of.

I would like to take a few minutes just to get feedback from other GMAC panel members, both on the comments around challenges and actions that our panelists raised but also if there are any other challenges or actions that you would recommend from a buy-side perspective. Ms. Guest?

MS. GUEST: While I am not speaking from a buy-side perspective, I really thank you for your remarks. It is really helpful to have had you shed some light on the challenges. And I think from this perspective of end-users and smaller swap dealers, I think a lot of those challenges are shared.

One that Mr. Grant glossed over a little bit but I think was sort of implied in what you said is the data challenges. In some cases depending upon how your booking systems work, you may have different asset classes that you use different booking systems for. And so the data challenge of flattening that data, if you will, to be able to feed everything into the model can actually be an extraordinarily, massive project. So I am sure that is probably part of what you guys are looking at, but I did just want to call attention to it because the data challenges are actually pretty significant.

I also support a lot of what you said, Ms. Yun. I think the challenges that you see are things that we are seeing as well and in some ways living through. And one of the things I wanted to just call the committee’s attention to is a letter that I think came in late last night but is in the packages. It is a letter from Reed Smith that highlights another logistical challenge, if you will, that comes up where there are conflicting models at play. And I think it is really important for the Commission to take a look at that on behalf of the smaller swap dealers and end-users and others because there are some significant challenges if you have, say, a SIMM model versus a GRID model. You are simply going to see people turning off and saying, “I’m not going to trade unless our models are the same.” And so I think the proposal in the letter is at a high level to allow effectively substituted compliance but to say, “You can rely on -- choose between the two. You can rely on the big dealer to run their model. You will run your own risk management for double-checking. But you would rely on that dealer to calculate for the relationship,” which I think may address some of the complexities of the things you were pointing to.

So thank you again for you remarks. It is really helpful.

CHAIRPERSON KARNA: Thank you.

Ms. Bradbury?

MS. BRADBURY: Yes. I just want to go a little deeper on a couple of points. You covered so much stuff. So, just to clarify, how often are you supposed to do the AANA calculation?

MS. YUN: The AANA calculations are done through the measurement periods prescribed by the jurisdictional requirements. So, again, it depends. In some cases, it is done through the June, July, and August measurement period. In others, it is March, April, May. In some instances, it is on a daily average calculation. In other instances, it may be the last day of the month. Again, it varies.

And so the information that you are collecting from your clients if you want it to that level of accuracy and specificity, you would need to identify the dealer counterparties with whom you are trading and the AANA requirements in relation to that specific jurisdiction and ask the clients to collect that data on that basis.

MS. BRADBURY: So you are going to a pension fund client for whom you manage a piece of their money.

MS. YUN: Correct.

MS. BRADBURY: And you are asking them first to do this threshold calculation regularly, right, particularly if they are kind of close to the margin? And then you go to every dealer you -- let’s assume they are over the threshold or near the threshold on AANA. You then have to go to every trading counterparty and ask them to do a calculation on all the business they do with that pension fund but with all of their managers.

MS. YUN: Yes. Unfortunately for the swap dealers, they are not going to also have transparency to the clients' overall trading activity outside of the trades that are done with them. So they are reliant as covered swap entities, you know, for the client to confirm whether or not they exceed the AANA thresholds for that particular year. So, again, there is a lot of reliance. In some cases, some dealers have asked for, you know, representations, which is quite alarming because, again, the numbers and the feedback you might be getting from clients may not be exact. It may be just based on using more of a blunt calculation across their portfolios and not getting into the nuances. But, you know, again, once you get that information, you have to go notify the dealers that that particular account is now potentially in scope, has crossed the AANA threshold. And that is when you begin to dialogue and the focus on whether or not they also will exceed the 50 million.

MR. GRANT: And that is where we talk a lot about client communication and education, because so many of these pension funds, a lot of the clients we work with, they are not digging into the details of the rule. So they don't understand the heavy lift that they have in front of them. And then what we have even seen since the addition of the new threshold category or the one-year delay, we have had certain clients who just say, “We heard there is a delay. Talk to us later,” like not even wanting to have the conversation now, though there is a bit of a lift on their part as well.

MS. BRADBURY: And let’s say you are managing a piece of a client’s portfolio and your exposure isn’t that big for what you do and you are notified by the client or by the dealer that you might have to put in place all of the contractual things. It is obviously a little hard for you to predict, but are you going to just stop trading swaps for that client? You know, is there going to be some sort of a degradation of your investment strategy because you decided it is basically just not worth it, you can’t handle or they can’t handle the compliance burden to use these instruments?

MR. GRANT: I mean, I think there are going to be a lot of individual client discussions and internal discussions about what makes sense given the magnitude that this happening across your entire client base essentially. And it may not just be our decision, but something Wendy and I have talked about before is that dealers may be making decisions as they are trying to think about the effort to put in place all of these agreements. And at some point, they may say for a given client, “I have a series of asset managers working with them. And some may have only a sliver of that overall account. And I am going to put them to the back of the line and may not get to their documentation until I have worked through everyone else.” So it goes both ways.

MS. YUN: Yes. I would agree with Richard. It is not only our independent decision but, again, of the dealer counterparties. And, again, it is dependent on a number of factors, including the type of portfolio that you are running for that particular client, whether or not you can gain the similar types of economic exposures through other instruments or not. Again, the dealers really hold the cards, too, because you may run a very small hedging book or, you know, FX book with that particular dealer. They could decide to put you at the back of the line or to tell you to please move your positions because they would rather deal with the accounts, you know, that are much more heavy use of the 50 million. Now, that also puts the smaller asset managers and those with the smaller trading books, you know, at a more disadvantaged position because, again, you know, with dealers having to weigh the resources and the cost-benefits, you can see how in some cases, they are going to be left, you know, on the sidelines.

MS. BRADBURY: All right. And, then, I will just make one other comment that is more from our perspective, and that is that as a firm, all other things being equal, we prefer cleared products. It is more efficient. We have to post margin on non-cleared swaps already, as I mentioned. We've had to do that for a very long time. And so, you know, if we can use a futures contract, it is very efficient. You know, economical, it is a great thing.

But there are products that we need to use to implement investment strategies that just aren't available in a cleared form. Maybe there are particular, you know, specialized, they have terms that don't match. There are obviously clear business reasons why that. And so I think we would really view it as extremely unfortunate if all of the regulatory burden, which doesn’t have a clear impact on risk reduction, ends up making these markets for uncleared swaps less efficient, harder to access, all of those things because we only use them where we don’t have other good choices. And I think that is just an important thing.

You need to preserve the market for these kinds of instruments and not unduly burden it. I think a lot of the suggestions that are in these comment letters and other things would really help reduce the burdens, in particular, in ways that don’t affect systemic risk. And I encourage the Commission to consider them.

CHAIRPERSON KARNA: Thank you.

Do we have any questions or comments on the phone?

(No response.)

CHAIRPERSON KARNA: All right. With that, thank you very much, Ms. Yun and Mr. Grant. And we will take a 10-minute break.

(Recess taken.)

CHAIRPERSON KARNA: Great. So we are going to continue our deep dive into margin with our third panel, where we are going to hear about the custody banks’ perspectives on implementation of the uncleared margin rules. We are going to start off with Dominick Falco, who is the managing director and head of segregation at BNY Mellon. And we will also hear from Judson Baker, who is the head of product development for derivatives and collateral services at Northern Trust.

MR. FALCO: Good morning. Thank you very much. And thank you very much for allowing us to have the opportunity to express the view of the marketplace from the custodian.

To maybe put this all into perspective, I would just like to kind of wind the clock back to 2016. I have been at the bank for about 12 years. And so I have been overseeing this process since the inception and, in fact, some of the buildup prior to the first go live.

In 2016, from the BNY Mellon perspective, just to give some numbers to add some context to the discussion, we set up approximately 600 accounts or so. In 2017, we set up a further 400 accounts. And in 2018, we set up about 500 accounts. This past year, we set up 1,000 accounts, so, basically, two-thirds as many as were in the program and live to date.

I would mention that there has been a lot of publicity, I would say, about the first phase. And so some of the delays as it related to the custodians in terms of being able to set up those accounts on time -- and that really was, you know, from that point in time an issue of doc negotiation and, really, the flow of documents. What I would say is the industry has gotten much, much better in terms of their ability to negotiate those documents, negotiating the account control agreements, which govern the segregated accounts at the same time that the CSAs are being negotiated as well. So within the 1,000 accounts that we set up in 2019, frankly, with very, very few issues, all of those were set up on time.

Interestingly enough as it relates to the discussions around the $50 million threshold, some accounts, a further 100 of those, have actually been delayed to post September 1 simply because the size of the balances and the expectation for being able to or requiring to exchange collateral really wasn’t there. So, in effect, really, this phase has been quite large.

Looking forward to 2020, our guesstimations from our perspective is probably setting up about 2,400 agreements, so from that perspective more than doubling where we are from this year. So, really, the road forward is really an uphill one.

Really, from our perspective again, it is -- predominantly two documents that we're the most focused on, is the account control agreement as well as some will say the eligible collateral schedule is a separate document, but, in fact, they form a package. The account control agreement is really an important doc for any of the participants to determine at the very, very outset which custodian and which regime they actually are planning to use to segregate their collateral. The custodian and the ultimate regime that they and their counterparty fall under will dictate the documentation that is required. There are four tri-party custodians: Euroclear and Clearstream, who are the ICSDs; JPMorgan; and ourselves. As you deal with an ICSD versus a traditional custodian in the tri-party space, the documentation is slightly different. And, similarly, if you are dealing with an EU 27-regulated entity -- and all four use those for the purposes of dealing with EU 27 clients post-Brexit -- there are additional documentation requirements that need to go into play.

Some of the issues around the documentation really are the interplay of the CSA as well as the account control agreement. One of the issues that the industry has raised to us on a number of occasions is that it is really actually the ISDA agreement that delays the finalization of the account control agreements. And so oftentimes we find these bottlenecks that are happening at the very, very end of the negotiation period. As I mentioned, there are fewer of those this year, but I can see going into 2020 that we would expect that that number would increase again.

From BNY Mellon’s perspective, we really are doing a thorough review of our documentation. We are looking at much of the optionality that we currently have in our documentation and then opening that optionality up further to clients so that we can reduce the amount of the bespoke negotiation that we need to do on a going-forward basis. Ideally, you know, our desire would be to get to a non-negotiated document on its surface but have a number of options that clients can actually opt into or opt out of.

In addition, we are looking at utilization of the ISDA Create program or the platform in order to make doc negotiation and then ultimately the consumption of those options and the documents much, much faster on our side. So, really, you know, our perspective is going into 2020 and 2021, we really need to look at as much automation and easing the burden as much as possible.

From the eligible collateral schedule point of view, I think, you know, a lot was raised about cross-jurisdictional issues. And it really is the cross-jurisdictional issues that make the eligible collateral schedule a little bit of a delay in terms of completion. What we see is that the eligible collateral schedule is generally the last document to be completed, even after the account control agreement and the CSA. And, really, it is an issue of the regulations will require certain amounts of collateral, certain types of collateral with prescriptive haircuts and concentration limits. I always say if you think about that the regulations put the acceptable collateral into a box and then depending upon the types of regulations that the counterparties are impacted by in a cross-jurisdictional space, that would actually make the box smaller. And then as the individual parties, particularly the collateral receiver, takes a look at the type of collateral and then negotiates that down, it becomes smaller still. And this process often takes a while.

What we had seen with dealers in the first couple of phases was really to have equivalence in terms of those collateral schedules and generally to have them as broad as possible. I think as we move into the buy-side -- and this we have seen with some buy-side clients -- certainly with some of the alts that have been impacted in the past couple of phases, their view is to potentially have a wide type of collateral schedule, to ultimately make the cost of collateral that would be priced into the trade, as I think was raised earlier, less burdensome. So the past phase, we have seen more asymmetric collateral schedules, as opposed to the symmetric ones that we have seen in the first couple of phases.

A couple of other things, just really to note from our perspective. We have engaged in client outreach for about 18 months in terms of notifying clients about the regulations, bringing in some of the industry participants to explain the different pieces around the regulations. And we do these in a variety of roundtables with clients. Typically what we have done, certainly in the U.S., is really have those roundtables by client type. So we have had insurance roundtables, asset manager roundtables, alt roundtables. As we go internationally, what we have done, really, has been more regional. So we have had them in some of the key capital cities in Europe and Asia as well. And, really, the importance is really to raise the awareness of the regs; introduce some of the issues, such as the calculation for IM and the SIMM model, bringing in some of the industry constituents to really explain those to clients. The feedback has actually been good. And I think what we have seen is a lot of engagement from clients very early on.

In terms of what we are seeing for 2020, right now, we are already in the phase of client onboarding. So the good thing I think that we have seen over the past four years is the mantra that we and many other industry participants talk about of it is never too early to start has actually started to take hold.

We have seen from some clients, certainly in the alts community, those that are initially or already posting initial amounts, so house IA or, you know, a number of different phrases around that, some of those clients have actually said that they want to move into a tri-party structure and their intent is to actually have that up and running by call it the end of this year or early next year with the view of being able to post their house IA and then ultimately the regulatory IM through that same account.

One other thing that we have noted from the clients that have started with us on the buy-side again, predominantly alts, most of them are actually using the greater of methodology of collateralizing. So this is one where there is a house IA number and then there is a regulatory IM number. The calculations are both made. The greater of the two is the number that is actually posted. Ultimately that account needs to be reg-compliant. So it is documented under reg-compliant documents. The collateral types are reg-compliant collateral types. And so it eases a little bit of the burden of having multiple accounts that are out there.

Specifically to the number of accounts, I know there has been a lot of discussion around the implementation or the recommendation, I should say, of the 50 million threshold. From BNY Mellon’s perspective, we are very supportive of this. I think one of the challenges that we saw very early on in the discussion was the potential for a number of accounts that would need to be set up, tying up legal, onboarding, and other resources within the firm, which, frankly, would never be funded. And so from our perspective, to not have to do that is actually a good thing, rather than having to jump through all of those hurdles.

One other thing that I really did want to raise -- and I know a lot of discussion has gone on around the SMAs and, really, the notification into the asset managers as it relates to the ultimate asset owner declaring themselves as being in scope. One of the concerns I think from the custodians’ perspective is any delays that come in through this process actually impacts us to a very large degree from the perspective of KYC and AML. From our perspective, whether you are a collateral provider or a collateral receiver on our program, we do need to do KYC review of accounts. And any delays in terms of identification of those accounts has a material impact to our ability to set up clients on time. From that perspective, anything we can do to speed up the disclosure of clients that are in scope would actually help everybody through the whole process. From our side, when dealers are posting to those clients, we will still have to do that KYC as well as any KYC that we would do if those particular clients selected our firm or any other firm as their collateral-providing entity.

With that, I will hand it over to Jud and leave it open for questions later.

MR. BAKER: Sounds good. Thank you.

I don't want to repeat much of what Dominick just mentioned, but custodians and asset service providers provide generally two lines of service as it pertains to uncleared margin rules. Some of our clients select us to become their collateral operations outsource provider. So we are the ones on their behalf calculating the initial margin and facing off against their counterparties, effecting the transfer of securities to meet the margin regulations.

And, then, there is the custody side of the business, where we offer collateral segregation services. That second bit is what the focus is here today. I guess I am representing probably some of the smaller custodians that haven't been impacted, mainly because the types of clients that we support are entirely buy-side. We don't have any sell-side direct customers. And so what we are aiming to do is to provide a service for the buy-side. We think it is a natural fit for our clients to keep these accounts under one roof so we can effect transfers between one account to the other.

So the starting point for us is to make sure that we have a standard account control agreement. And I think most people know or maybe it is -- I am not sure I can use that assumption, but ISDA has a legal working group where they have retained external counsel and they are going through each of the major custodians, at least U.S. account control agreements, as well as U.K. account control agreement and any other jurisdictions where their members are demanding them review these agreements.

And custodians have been offering this type of service for a number of years, decades, either to support independent amounts or to support margin help for U.S.-registered mutual funds under the 1940 Act. So there is a lot of familiarity around this service. And a lot of our clients already understand how it works and how these agreements function. The great benefit to a firm like us and I think other custodians is going through that legal process to vet your agreements would theoretically leave it to a better place where you are going to negotiate downstream with your clients and your dealers. There won’t be too many negotiable points. We shouldn’t see too much of a variation between one account control agreement and the next. What helps us with that is that ISDA panel is holding a bunch of representatives from the sell-side and the buy-side.

So, theoretically, we like to think through that that is going to help the process entirely for the account opening end of things. We don’t see too many hurdles on our side. We can quantify the number of clients that we think are on scope and at what points. And we also have a view into which dealers they are trading with.

So we have a good feel for how much business will come our way for these accounts. But what we are absolutely advising our clients is let’s negotiate the account control agreements first. And the account opening process will be a trigger point down the road. And, you know, from the regulatory relief that we saw, I think that is a great relief, not only to the custodians but to the asset owners, so they don’t have to, you know, start paying for services that they don’t need.

So most custodians will charge for these accounts. It is like nominal account charge or basis point fee of the assets in there, but there typically is some kind of flat fee in there. If the accounts are going to sit there dormant, then there is really no point for the clients to have to pay fees. So what we expect and what we are going to advise our clients is, again, let’s negotiate the account control agreements so at least we get that out of the way. And then when you get close to that 50 million threshold -- maybe it is 30, 35, 40; it is up to the client -- they give us a 2-week notification timeframe. And then we will effect the opening and alert both parties that the account is open.

So we do see practical means for carrying out these margin regulations, at least from an account opening perspective. As I said before, the majority of our clients for these segregation services will be existing clients of our organization already. So that knocks out a lot of AML KYC aspects.

We are starting to get interest from non-custody clients of our organization. And I think it is because, you know, they might be facing a queue with their other provider, for whatever reasons. So we are evaluating this, but one of the safeguards in play is if we already have that contractual relationship with that organization, we already are the custodian of their accounts, it is an easier solution for those organizations, as opposed to supporting this from an instance where external transfers of assets come into the bank.

Outside of that, as I said before, the custodians have been providing this type of service in the past. One of the fears that I think the industry had is that right now, it is a heavy paper-based flow, secure email, faxes, dealers logging into custodian portals and things like that. I am speaking from my organization. I think I am speaking for a lot of other custodians. That is all going to move away. Most custodians, including my organization, are adhering to industry standards on how to automate these messages, whether it is through SWIFT or a utility. So there is relief by all parties. It does require testing between mainly the dealers but also the large buy-side firms with the custodians to effect that. So I just wanted to point that out, that, you know, it is a pain point historically but that pain point should be going away. And it is for good reasons, not just to comply with the margin regulations.

The one challenge we see with the margin regulations -- and it has already been discussed. So I am not going to bang on this point too much -- is the eligibility rules and cash as a permissible asset. And for us as a custodian, it is forcing us to offer or to launch a Treasury-only fund. With that, you know, we don’t have too much outside interest in a Treasury-only fund from our clients. They are very comfortable with money market funds. So I think the only thing really driving this is so that clients of ours that wish to pledge initial margin as cash can continue to do so.

Practically speaking on our side, partnering up with our asset management firm, we are looking at how early that notification needs to come to us to move the cash, whether it has to be first invested in a Treasury fund and then transferred as an investment into that seg account or can it just come in the form of cash and be reinvested into that Treasury fund. There are some operational hurdles that we as a custodian have to go through. There are certainly haircut calculation concerns that the dealers are facing when cash is permissible on whether or not they apply a zero haircut overnight or is it an 8 percent haircut, 12 percent haircut? You have got to look at the underlying fund. So there are complications now that we all are wrestling with because of the eligibility rules and the reinvestment of cash as margin.

I think that pretty much covers all of the things that I want to talk about. So I will open it up to questions or comments.

CHAIRPERSON KARNA: Thank you very much. With that, I am opening it up for questions or comments from panel members. In particular, have you yourselves experienced any particular challenges, either raised by our panelists or otherwise, with respect to custodial arrangements? And in the interest of being solution-driven, do you have any suggestions for ways to address some of those challenges?

(No response.)

CHAIRPERSON KARNA: Can I open it up to people on the phone for any comments or questions for our panelists?

(No response.)

CHAIRPERSON KARNA: I am allowing for a louder pregnant pause because apparently I was too quick on the draw the last two panels.

Does anyone have views on steps custodians could be taking beyond what has already been highlighted that they are taking to help address some of the challenges around volumes for the next couple of phases?

(No response.)

CHAIRPERSON KARNA: All right. Well, you guys did an excellent job, very thorough. Apparently you have got it all under control. So thank you very much for your time. And, with that, we are going to shift to our next panel.

(Pause.)

CHAIRPERSON KARNA: Great. So now we are going to shift to cross-jurisdictional issues in the implementation of uncleared margin rules. And to present on this topic, we have Tara Kruse, who is the global head of infrastructure data and non-cleared margin for ISDA.

MS. KRUSE: Thank you, Angie. Thank you to Commissioner Stump, to the chairman, to the other commissioners, and the GMAC Committee for having me today to speak on cross-jurisdictional issues with respect to the margin requirements.

Although global regulators have based their margin requirements on the BCBS-IOSCO framework, there are still differences that are causing challenges for market participants who are subject to requirements in multiple jurisdictions. In some cases, those variations are based on the party scope or the product scope subject to that regulator’s oversight. But, nonetheless, that can cause complexity issues, cost issues, and level playing field issues for market participants. So let’s look at a few of these today.

First off, let’s talk about AANA calculation. This has been brought up, but here are some of the differences that we are seeing in this world. There are differences in methodology timing for the calculation period as well as applicable compliance dates. In the U.S. and Brazil, the average aggregate notional amount is based on a daily average of the gross amount of the derivatives over the calc period; whereas, the rest of the globe uses only the month and total. So 3 observations, as opposed to 64 observations that were just required in the AANA calc period for the U.S. for phase 5 that just completed.

In terms of the calc period itself, following the phase-in period, the U.S. moves to a June-to-August material swaps exposure calc period; whereas, the rest of the globe stays with March to May. This means parties have to run two separate AANA calc periods and two separate periods of notification to their counterparties in the event they have a change in their status. That is especially challenging in cases, as was pointed out earlier, for separately managed accounts, where it may be difficult to aggregate the necessary information.

Compliance dates as well, finally, following the phase-in period, the U.S. and the E.U. moved to a calendar year compliance cycle while the rest of the globe stays on a September-to-August cycle. These bifurcated dates create a lot of complexity. You can see here is the calendar through January of 2023 if you take into consideration all of the different AANA calc and compliance date periods. If these dates were aligned, it is much more simple.

Product scope. Differences in product scope add costs and complexity to cross-border compliance as firms have to implement mechanisms to identify jurisdictional application and tag this on a trade-by-trade basis. Most parties use a higher-of method to calculate a separate initial margin calculation for each jurisdiction and then settle the higher-of amount, but in some jurisdictions, like the E.U. and Japan, parties are allowed to use what we would refer to as a broad product set, meaning you can include products that are subject to non-cleared requirements in any jurisdiction in your calculation.

Just to point out a couple of the differences that are highlighted here on this slide, the E.U. is an outlier for VM for physically settled FX swaps and forwards. We do expect them to resolve that in an upcoming amended regulatory technical standard.

Also, the other one getting a lot of attention these days are equity options out of scope in the U.S. That is not the case in some other jurisdictions. The E.U., Hong Kong, Singapore, and Korea all have delayed application of requirements to equity options at this point, but those expire in early next year. And many market participants are concerned about the impact of that, especially in terms of a level playing field between the U.S. and the E.U.

Settlement timing. The U.S. is most restrictive in terms of settlement timing with its T+1 requirement. This can be particularly problematic for counterparties trading between Asia and the U.S. It prevents parties from settling using some collateral that may take longer than T+1 to settle. And it is expected to be more problematic as we move into the final phases, where parties might be more likely to use the third party custodial structures. And it may take more time to do the settlements.

Eligible collateral. So when we have multiple jurisdictions involved, the parties have to agree an eligible collateral schedule that reflects the intersection of the collateral that is allowed in each of the relevant jurisdictions. This does create some restrictions on what is allowed to be used. The example that has been highlighted over and over today is money market funds. We do expect that because of the T+1 settlement required in the U.S., because of the U.S.'s requirement to reinvest cash that is used as collateral, and because of the use of more third-party custodians in the final phases, parties will want to use money market funds more. Unfortunately, there is a direct conflict in the rules between the U.S. and the E.U. in terms of the conditions for money market funds, repos and reverse repos are allowed to be used in the E.U. They are not allowed in the U.S., for instance.

In August, ISDA sent a letter on behalf of six industry associations asking U.S. regulators to expand the types of money market funds that can be used as collateral, including allowing use of non-U.S. money market funds. An equivalence determination from the USPRs and respective E.U. rules would also help mitigate the situation.

Inter-affiliate IM. Currently, the USPRs are the only jurisdiction that requires inter-affiliate initial margin. That might change, of course, as a result of the rule that was put out earlier this week or last week and approved by the FDIC and the OCC. The E.U. also has an inter-group IM requirement. It is on deferral until early next year. And they are currently looking at potentially extending that or hopefully eliminating it altogether.

IM model governance. This has been touched on a bit today as well following the comments that Rafael made and Wendy made on this topic. Just a baseline a bit. So ISDA conducts robust and regular testing of the ISDA SIMM model with global dealers in order to prove that the model is regulatory-compliant. And then, in addition, the dealers that use SIMM do regular internal backtesting of the model to ensure that the IM amounts meet or exceed the regulatory requirements for all of their in-scope portfolios.

Despite these efforts, some jurisdictions also impose individual model validation requirements and backtesting requirements on smaller counterparties, who might lack the resources, expertise, or infrastructure to conduct such measures. That could impact swap dealers in the U.S. that are in phases 5 or 6, but mostly the concern these days is about the E.U. requirements that apply, of course, to the broad spectrum of counterparties. And the concern is that those counterparties won’t be able to use a risk-sensitive model, like the SIMM. Our estimates do show that the bulk of the counterparties who will come into scope in phase 5 and 6 or more counterparties from the E.U. and U.K. will come into scope then from other jurisdictions. We are engaged with E.U. regulators on this matter to try to mitigate the impact.

And although this discussion is on cross-jurisdictional initial margin issues, I would be remiss if I did not raise potential issues within the U.S. borders. The SEC, of course, did finalize its margin requirements recently. And although they did come a long way from their proposed rule to their final rule in terms of aligning with CFTC and USPR requirements, there are still some primary differences that are likely to cause challenges for market participants.

First off, I will mention party scope. So the SEC rules don't have an equivalent for the material swaps exposure level or the financial end-user definition or that they rely on a list of exemptions, like a commercial end-user exemption. But this means there might be smaller counterparties not caught by U.S. rules already, who will be subject to SEC margin requirements.

Also, security-based swap dealers are required to collect IM but not post IM. And there is no IM exchange between dealers. For some market participants, this is a welcome divergence, but it does create a good deal of complexity in terms of trying to figure out for parties in the U.S. which transactions are in scope between swaps and security-based swaps when you have to post and when you have to collect.

One of my colleagues took a stab at trying to figure out what that logic looked like. And he came up with 32 variations that a swap dealer alone might have to look at to figure out when they might need to post or when might they need to collect for their swaps and security-based swaps. And that is not even taking into consideration MSPs.

Next up I will mention segregation. So under the SEC rules, a party can elect third party segregation, as we currently have, or omnibus segregation or they can waive the segregation requirement altogether. The existing suite of IM CSAs is built on the third party segregation model. So we would have to have new docs or new provisions for separate treatment of transactions under the SEC. It is not clear at this point how many counterparties will be eligible to take advantage of this opportunity. If they are subject to a third party segregation requirement in any other jurisdiction, including under USPR rules, then they may not be able to take advantage of this.

Haircuts for collateral. The SEC has their own standardized set of haircuts for collateral. And they actually vary for standalone security-based swap dealers versus broker-dealers. A security-based swap dealer can elect to apply the CFTC’s haircuts, but broker-dealer security-based swap dealers have to use the SEC’s haircuts for equity security-based swaps. So if a party is subject to the SEC, you might have to use the more punitive haircuts if they are more punitive than the other U.S. rules.

IM calculation. The SEC rules don’t use the BCBS-IOSCO regulatory schedule for calculating IM. They don’t use that same grid. Rather, they have distinct methods for IM calculation that are specified for each of broker-dealers and separate ones for standalone security-based swap dealers and separate ones for equity and separate ones for CDS. This would make it very difficult for their counterparties to replicate that initial margin amount to check the amount that they are being required to post. A broker-dealer can apply to use an IM model like SIMM but only for its non-equity security-based swaps. A standalone security-based swap dealer can apply to use an IM model like SIMM for both equity and non-equity security-based swaps.

Portfolio margining. Standalone security-based swap dealers can use a quantitative model, like the SIMM, to portfolio margin equity security-based swaps and swaps subject to further coordination with the CFTC. CFTC rules don’t currently contemplate portfolio margining, but this approach was acknowledged in a staff letter from DSIO and DCR to ISDA back in 2016. So this is an area that we would look for the agencies to collaborate around, although there are potentially still challenges with being able to do this since there are limitations on the SEC side in terms of what can be portfolio margined, despite the fact that swaps and security-based swaps are being margined together on the USPR side.

As was mentioned earlier, the SEC does have an alternative compliance mechanism. A standalone security-based swap dealer can elect to comply with the CFTC's margin rules for their security-based swaps provided they are not clearing for clients and provided their security-based swaps don't exceed the specified margins. It is yet unclear how many security-based swap dealers will be eligible for this alternative.

An effective way to mitigate the cross-jurisdictional margin issues is by international deference or even domestic deference, but to date, substituted compliance is available in very limited cases. I would certainly encourage U.S. and global regulators to prioritize equivalence determinations to help simplify this complex world of cross-border margining.

CHAIRPERSON KARNA: Thank you very much, Ms. Kruse, for taking an already complex topic and helping distill some of the key issues that can be fruit for further discussion.

So, on that, we have a lot of GMAC members who have operations in multiple jurisdictions. So I am interested in people’s perspectives on what are some of the most challenging aspects from your firms’ perspective with respect to some of these jurisdictional differences? And, furthermore, are there any suggestions you would have, either consistent with what ISDA has already presented or any other suggestions, to help mitigate some of those differences? Ms. Guest?

MS. GUEST: Yes. I think one of the things that we would appreciate the Commission to focus on is the settlement timing. The T+1, 2, 3, 4, 5, promptly differences are not only challenging because of the fact that different jurisdictions have different requirements, but also when you have operations in multiple jurisdictions, you are running certain operational processes at a particular time of day. There are cutoffs for those processes. There are all kinds of logistical things that happen operationally within firms, let alone bringing the complexity of the custodians and if you have instructions that have to be passed and things. So I think the T+1 requirement is one that I think a lot of folks would probably appreciate the Commission taking another look at.

CHAIRPERSON KARNA: Thank you, Ms. Guest.

On the phone, do we have any comments or questions, either for our panelists or on the general topic of cross-border challenges and potential solutions?

(No response.)

CHAIRPERSON KARNA: Mr. Yamada?

MR. YAMADA: Thank you.

I think that was an extremely illuminating presentation on many of the different inconsistencies and, frankly, some of the things that I guess from the dealer perspective, you know, we consider many of the operational perspectives but not necessarily see some of the impacts on end-users. So it is quite illuminating to see how complex and how diverse this is.

I think, I mean, from our perspective here and our mandate here on this panel, it definitely bears additional scrutiny because, I mean, just the number of line items that you identified, you can see that implementation is just -- I mean, it is going to be a practical nightmare. So perhaps, you know, in the course of the implementation and the roadmaps and the timelines, we should also attempt to, I guess, increase that harmonization globally and, I guess, also perhaps take a look at prioritizing, to Commissioner Quintenz's original point, more of a risk-based approach. Where are the real systemic risks associated with many of these complexities and which ones are quite irrelevant and just an operational burden? And perhaps that might be something we could focus on.

CHAIRPERSON KARNA: Thank you.

Ms. Bradbury?

MS. BRADBURY: Tara, I wonder if you could just talk a little bit more about how the SIMM model was developed and the governance and the involvement of actual regulators in that model since I think it is a pretty central part of this whole risk reduction system we have put in place.

MS. KRUSE: Yes, happy to. I mean, I think when the rules were being developed and people knew what the landscape was in terms of what the requirements were going to be, it became clear fairly quickly that having multiple models or each dealer having a different model, each counterparty using a different model was just not tenable. Parties would not be able to replicate the calculations that parties were making because, of course, you are calculating the amount that you are asking your party to post to you. So how can they replicate that? How can they dispute it?

So the industry came together to say it is just not possible. We can’t support many, many different models. There is a huge value to having a standardized model that we can all apply where it is transparent. So I can calculate what I am posting to you. I can calculate what I am asking, you know, you to post to me. And we have that check in place. It needs to be transparent.

Also, there is clearly a lot of work involved in developing a model and maintaining a model. And to have many, many parties having to replicate this over and over again just simply isn't supported. So the industry came together and came to ISDA and worked together through the thought leadership of many of the major industry participants to pull together ideas in terms of what would be a workable solution for calculating initial margin and an approach that would balance having appropriate risk coverage that aligned with the requirements but also not having the model be too complex because it was important that people could calculate quickly and that it could be approachable for a variety of market participants. Once you got it set up and you have the inputs, you can actually calculate SIMM on a spreadsheet, right? As was mentioned earlier, it is really the setup and the data that you need that is the most complex part, not the model itself. And to date, yes. I mean, the model is being used across the board by almost all market participants that have phased in. And it is appropriately conservative to meet global regulatory requirements. There was broad engagement with regulators, especially in the E.U. and the U.S. and Japan, early on in terms of the development of the SIMM to make sure that it was going to be satisfactory to regulators. And we have continued engagement with regulators as we monitor quarterly the performance of SIMM and send out reports across the globe to assure everyone that, in fact, the model continues to perform as expected.

CHAIRPERSON KARNA: Thank you.

Ms. Belich?

MS. BELICH: Thank you.

I echo the comments that were made earlier about how well this kind of lays out the complexities, even at a high level, because I think within this, as I am sure most other banks in this panel would kind of agree that there are kind of deep, deep roots from each of these issues beyond just what we see here.

Kind of turning to the product scope, I am just wondering if you can offer a little bit more kind of detail around -- for example, you mentioned equity derivatives. And I know that from a dealer’s perspective, you know, one of the things that the industry sees a lot is not only the regulatory arbitrage that you had referred to earlier and I know was discussed in the earlier panels but also how that kind of leads to ongoing issues, maybe even more from a dispute resolution perspective. So, for example, if there are issues where, you know, dealers are even taking a different product interpretation for in the equity space under EMIR, right, how that leads to kind of ongoing issues that still remain unresolved from an ISDA perspective.

MS. KRUSE: Yes. We certainly do see that come up. When we seek information from parties about disputes that they have in relation to their IM amounts, what they indicate primarily is that there is not an issue with the calculation of the initial margin amount. Not so often, it is an issue about the inputs. It is often about the portfolio. It is about the trades that each party has put into the portfolio to do their IM calculation. Those are the differences that they see and have to resolve in order to get to the right IM calculation. And so sometimes that is a determination. Is it a swap? Is it a security-based swap? There seem to be areas where there is a lot of consistency. Is it an equity option? Is it not? I mean, these are fundamental issues that do come up.

As part of our SIMM governance forum that helps do the maintenance of the SIMM model, parties do sometimes raise these issues about product scope. And we try to look at it and provide guidance where appropriate, but at the end of the day, there are inconsistencies.

We do encourage people to prepare ahead of time and test with their counterparties before they go live because that is often a good opportunity to identify where you might be identifying a product differently than your counterparty and, therefore, would bring it into scope differently than they would when you begin to calculate your initial margin.

CHAIRPERSON KARNA: Any other questions for Ms. Kruse or any other comments around cross-border complexities and the impacts on business?

(No response.)

CHAIRPERSON KARNA: On the phone, anything else?

(No response.)

CHAIRPERSON KARNA: Great. We will now take a break for lunch. Thank you.

(A luncheon recess was taken at 12:15 p.m.)

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

(1:47 p.m.)

CHAIRPERSON KARNA: Great. So before we get to our last panel, I just wanted to raise an additional piece of business, really, to follow up from the very helpful and detailed panels we had this morning on our first deep-dive topic, which was margin. It seemed like there was a great deal of wonderful insights from a number of our panelists as well as open issues for consideration that would be very helpful to discuss in a smaller subcommittee of the GMAC if there is an appetite to set that up. And the idea would be to set up, the Commission would set up, a subcommittee of the GMAC, which could consist of both members of the GMAC and nonmembers, to really take a deeper dive and look at some of the issues in advance of phase 5 and phase 6 that the industry is grappling with and help formulate some recommendations to give to the Commission in a more formalized way than we have been able to do and dig deeper than we were able to do this morning as well as in the prior GMAC.

So I know that Commissioner Stump is in favor of at least me raising this topic with you. So I open it up for discussion if people think that that would be a worthy subcommittee to recommend to the CFTC to set up. Any thoughts? Mr. Yamada?

MR. YAMADA: I would most certainly be supportive of that and would love to participate.

CHAIRPERSON KARNA: Any other thoughts on the idea? Ms. VedBrat?

MS. VedBRAT: Yes. I would be supportive, too. My understanding is that we would want to do this relatively soon, right?

CHAIRPERSON KARNA: Ideally, the idea would be to capitalize on the momentum from this morning's discussions as well as previous discussions, suggestions already raised to the CFTC, and get a group of industry participants to quickly act upon some of those recommendations to formalize them for the CFTC.

If there is no further discussion, would anyone like to make a motion?

MS. GUEST: Thank you.

Yes. So I would move that the GMAC recommend to the Commission that it consider creating a subcommittee on uncleared margin or margin for uncleared swaps.

CHAIRPERSON KARNA: Wonderful. Any second to that motion? Ms. Bradbury?

MS. BRADBURY: Yes. I would second that motion.

CHAIRPERSON KARNA: Excellent. All in favor, please raise your hand.

(Show of hands.)

CHAIRPERSON KARNA: We have a unanimous approval of that motion. Thank you very much.

And, with that, we will go on to our next panel and our next topic. So our final panel today is going to be focused on EMIR 2.2 and the ESMA consultation. We have three presenters on this topic: Sean Downey, the executive director of global clearing and risk policy for the CME Group; Carolyn Van den Daelen, the head of regulation and compliance for ICE Clear Europe; and Jackie Mesa, chief operating officer and senior vice president of global policy for the FIA. I turn it over to you.

MR. DOWNEY: Thank you.

I will lead off with some background on the EMIR 2.2 and the ESMA consultations, but first I wanted to thank Commissioner Stump, the rest of the commissioners of the CFTC and CFTC staff; in particular, Andrée Goldsmith, for setting all of us up.

So, with no further ado, I will start with a little bit of background. The origination of the topic that we are discussing right now really started in June of 2016, when the U.K. referendum occurred and the U.K. voted to leave the European Union. I will note that that vote occurred about 10 days after most U.S. CCPs received recognition under the previous European regime. And in July of 2017, about a year later, the original European Commission proposal was released to revamp and overhaul the regime for non-E.U. CCPs in Europe, at the time with a focus on European monetary policy and the clearing of the euro.

Following the 2017 release, over the next 2 years, the European Commission, European Council and European Parliament negotiated the text of EMIR 2.2 and reached a political agreement in March of 2019. And we expect that it would be published in the Official Journal by the end of 2019, so in the next few months.

Following the agreement on EMIR 2.2, the next step is to issue a delegated act with regulatory texts covering three topics. Those topics include tiering, which is effectively the assessment of a non-E.U. CCP to determine whether it is systemically important; comparable compliance, which focuses on the ability of a systemically important CCP to rely on its home jurisdiction's regulations to "meet the European requirements"; and, finally, fees, which cover the fees necessary and proposed by the European Commission to cover the expansion of ESMA to oversee non-E.U. CCPs. There was a consultation that ESMA issued on these three topics in May of 2019, which closed in July of 2019. And I think each of the panelists will be covering some of the responses to those consultations.

To go into a little bit more detail, the result of the tiering analysis, which will be finalized by the European Commission we expect in early 2020, will be putting non-E.U. CCPs in two buckets. One bucket is Tier 1, which will effectively be treatment similar to what non-E.U. CCPs have today in Europe with some additional data sharing; and Tier 2, which features the direct application of European regulations to a non-E.U. CCP that is deemed systemically important.

From a criteria perspective, EMIR 2.2 created five criteria for the evaluation of whether a non-E.U. CCP is systemically important in Europe. As you can see, it focuses on, in most cases, the impact of that non-E.U. CCP in Europe ranging from the potential impact of a failure, the extent of its clearing European-denominated products, European clearing member participation in its markets, and its relationships with E.U. financial institutions. That EMIR 2.2 criteria is what ESMA then took in its consultations, which we will go into more detail in shortly, and expanded upon it to propose more detailed requirements to evaluate whether or not a CCP is systemically important in Europe. And that is what constitutes the tiering consultation. As I mentioned before, there are two other consultations that we will address, but primarily it will be the tiering and the comparable compliance ESMA consultations.

With that, I will turn it over to Carolyn to discuss the next slide in more detail.

MS. VAN DEN DAELEN: Sure. Thank you.

So, again, my name is Carolyn, and I am the head of regulation and compliance for ICE Clear Europe. ICE Clear Europe is just one of ICE’s six geographically diverse clearinghouses. And we serve global markets and customers in North America, Europe, and Asia. Each of these clearinghouses is subject to the direct oversight of our local domestic regulators, often in close coordination with and communication with other regulatory authorities with vested interests. And we are also reflective of the G20 reforms and the CPMI-IOSCO principles.

Just by way of background, ICE Clear Europe, which clears markets located in the U.S., the U.K., Europe, as well as OTC credit grades, is directly regulated by the CFTC, the SEC, the Bank of England, and the College of National Competent Authorities in Europe, which is already an EMIR construct. And so with the tiering proposal and the binding level 2 text that will come into force in the coming weeks and months, we are now starting to explore how ESMA will deem a CCP either Tier 1 or Tier 2. So on this slide before you, you have the five categories that Sean mentioned. Those are in the green boxes at the top. And then underneath that, you can see that there is a variety of text, which has 14 different indicators that ESMA has drafted in their consultation paper, which are the items that ESMA will assess when they are examining a CCP to be either Tier 1 or Tier 2.

I think it is important to note that the determination of the tier of a CCP has important legal consequences as well. Once you are deemed Tier 1 or Tier 2, then you are only legally allowed to provide clearing services into Europe. Without that authority, it is illegal for a CCP to provide access to its clearinghouse to European clearing members and European end clients. And so I think when we are looking at these criteria, it is very important to think not only how does it impact the clearinghouse but how it impacts the clearing members and their European clients.

So our intention is not to walk through the 14 indicators, but I think Sean and I and Jackie would like to just highlight certain of those. So the first indicator that I would like to highlight is indicator 1, “Assess the non-E.U. CCP’s ownership, business, and corporate structure.” What ICE identified with this indicator is a general theme that we see through some of the other indicators, which is a misunderstanding or a lack of a nexus as to how this indicator actually determines a CCP’s systemic impact on E.U. financial stability. In fact, when we look at this indicator, a CCP’s ownership, business, or corporate structure is more something that a CCP would provide information to its regulator once it is approved or authorized to provide services and on a supervisory basis. But we struggle to see how ownership and business and corporate structure impacts a systemic impact on E.U. financial stability.

MS. MESA: I am just going to highlight a few of the broader concerns. FIA filed a letter to ESMA per their consultation. And I wanted to highlight a few over-arching themes, rather than getting into the detail.

Something Carolyn just said is each indicator should have a nexus to the systemic risk of the E.U. or an E.U. member state. If you do look through each indicator, you may struggle to find the nexus to systemic risk.

Additionally, the indicators are fairly broad. I think there is a couple of issues with the broadness of the indicators. One is it leaves a lot of latitude to the assessor, so ESMA. That may be okay, but then you are going to constantly be questioning, are we being assessed similarly to our competitors or to the next CCP? So I think the indicators being too broad may lead to some questions about fairness.

Additionally, I think the broad nature of the indicators lacks legal certainty for the CCPs being assessed. So you would definitely want CCPs being assessed to be able to determine ahead of time whether they may or may not be in the category of Tier 2. And I think if you look across the indicators, you probably would have no idea how you would be assessed based on the broad range of indicators.

We made a few suggestions. One of them is probably tier -- sorry to use that word -- or prioritize the indicators, so which ones are really important and which ones are less important. Tier level 1 does not indicate that they can’t do that prioritization. So we suggest they do.

Additionally, beyond prioritization, they should also consider using examples. So I think if you look at ownership, what are you concerned about on ownership? And giving some examples would help the industry in making their own assessments.

MR. DOWNEY: Thank you.

I think I will just expand a little bit on both of the prior comments. It was noted, for example, in indicator 1 that non-E.U. CCP’s ownership, business, and corporate structure is not necessarily relevant to whether it is systemic in the E.U. We certainly agree with that and would expand on it. I was sitting before I was about to present on this panel, and I went through each of the indicators. And I underlined all of the language that we thought didn’t have an E.U. nexus and wasn’t a true test of systemic importance in Europe. And I ended up underlining parts of every single indicator. So I am not going to go through all of them. However, you can continue on that path if you look. For example, even at indicator 2, it starts off with an E.U. nexus discussing the clearing obligation in the E.U. currency denomination, but then it talks about the complexity, price volatility, and average maturity of the instruments cleared. Again, if that E.U. nexus doesn’t exist as a predicate, the fact that there is complexity, price volatility, or that maturity of those instruments isn’t really relevant to determining wither a non-E.U. CCP is systemic in Europe.

The same thing would be true if you look at indicator 5, the risk profile of a non-E.U. CCP; transparency, indicator 4. You could go on and on, but I think the primary issue that we are identifying is if you look at the EMIR 2.2 text, we interpreted it to suggest and require an evaluation of non-E.U. CCPs, keeping the impact of those non-E.U. CCPs on Europe in mind. And, unfortunately, the ESMA consultations from our perspective have not followed that approach and have created an expansive, somewhat vague set of indicators for the evaluation of systemic importance in Europe. And we think that that is not good for non-E.U. CCPs, for the global markets, or for our participants. And so we have some concerns about the tiering consultation from that perspective.

MS. VAN DEN DAELEN: Just building on those comments, it is important to note that in the level 1 text, which is binding law today, there is an obligation for ESMA to make the criteria objective and transparent. And, as Sean and Jackie noted, when you look at this criteria and the indicators under each category, that objectivity and transparency doesn’t always exist. So for indicator 6, where it says, "Assess the non-E.U. CCP's margin, default fund contributions, and eligible collateral," we would agree that that is important for ESMA to look at when they are assessing the tier of a particular CCP. However, without that objectivity and that transparency into what they are actually looking at in terms of margin and default fund contributions, it is difficult to assess how they will apply consistently and consistently tier the different CCPs who have different default fund contribution setups and margin requirements.

MR. DOWNEY: And if I can just add one point on that particular indicator. And that goes to the previous comments about E.U. nexus that we have all made. There is no tying of the variation margin, the initial margin, the default fund, to the E.U. In this indicator. It looks at it from an aggregate perspective. And from our view and I think from others' view, the fact that you have a certain amount of initial margin or have certain variation flows in U.S. dollar or some other currency that doesn't necessarily have an E.U. nexus isn't really relevant to the evaluation of systemic importance. So, once again, for this indicator 6, we think it should be tied to this point about E.U. nexus.

MS. VAN DEN DAELEN: And, finally, Jackie made a good point about using numerical tests or quantitative assessments. And I think that what is missing in some of these indicators is relativity and not looking at numbers in the absolute. So just for example, the total amount of initial margin denominated in Euro--so having that European nexus--held across all six of the ICE CCPs is just over 19 billion euro, which is only .12 percent of the total E.U. economy. So it just shows you you can look at a number as big as 19 billion, but in the scale of the E.U. economy, that is a very small percentage.

MS. MESA: The next proposal was on comparable compliance. This is really how the E.U. will judge whether they rely on home country regulation or EMIR requirements will apply.

Under the ESMA’s proposal, the comparable compliance assessment will be conducted on a CCP level that is different than the current equivalence assessment, which is done on jurisdictional level. It is requirement by requirement, a mapping of the non-

E.U. requirement to the corresponding EMIR requirement. The supervisory approach on how ESMA would actually eventually supervise the third country CCP as Tier 2 is still a little bit vague and remains unclear. But there are core requirements they put forward in the consultation response and non-core requirements.

The list of core requirements gets a different kind of assessment. It will be considered comparable when they are always equal or at least as strict or conservative as the corresponding EMIR core requirement. And if it is not the case, then EMIR will apply.

So if it is quantitative, so something that, of course, requires a number, it has to be as strict as the EMIR requirement. And if it is a qualitative assessment, it has to be as conservative as the EMIR requirement. For non-core requirements, it has to be similar to the corresponding EMIR non-core requirements to substantially achieve the respective regulatory objectives of EMIR.

Comparable compliance, they say even if the requirement by requirement doesn't match the EMIR requirement, they would then look at whether the requirement achieves the regulatory objectives of the corresponding EMIR requirements and effectively reflects the union's interest as a whole. I think that I have used the exact words because I think that is left up to what you think it might mean. I take that to mean objective-based outcomes, but it is a little hard to reconcile how they would do a requirement-by-requirement assessment and then at the end do an overall objective requirement. So I think you are one or the other. And to me, it is hard to have both in the same proposal.

MS. VAN DEN DAELEN: Sure. So just to expand upon the second line on this slide, which talks about the lack of clarity on the supervisory approach, in the consultation papers, it is noted that ESMA would presumably limit its supervisory authority to only those EMIR requirements for which ESMA cannot find a comparable requirement in the third country regime. However, two paragraphs after that, there is a statement by ESMA that, regardless of the comparable compliance assessment, ESMA retains full supervisory powers over a Tier 2 CCP.

So when a CCP is looking to apply to ESMA and to have a tiering and comparable compliance assessment, that is a cost that we have to analyze. And if there is a chance that ESMA will become a full supervisory authority, then that is something we have to add into the question as to whether we want to offer our services into Europe.

MR. DOWNEY: And just to add one more point on this slide -- and I think it is an important one that Jackie touched on -- the concept of comparable compliance, as she mentioned, is one of outcomes basis. It is one of evaluation of a regulatory regime to determine whether it is comparable.

As drafted right now -- and agree that the text is not entirely clear -- the idea that you would always have to be equal to or at least as strict or conservative as a corresponding EMIR requirement and if you are not, apply EMIR as a floor effectively undermines or eliminates the whole concept of comparable compliance and the reason being that if you think about it from a quantitative perspective, you could have a regime in two different jurisdictions that would have slight differences and are equivalent overall or one is even more conservative in most cases.

But in some small cases, that regime is not as conservative. And, as a result, you are applying the EMIR requirement either directly or as a floor, no matter what, because it is impossible, effectively, to always be at least as strict or conservative if you have two different requirements in two different regimes. So, effectively, what that language does is it eliminates the concept of comparable compliance as currently drafted.

MS. VAN DEN DAELEN: And I will just add that hearing what Sean just said is what are our concerns about having a regime of this nature. And it is really we don’t see how it can’t cause anything but contradictory requirements, duplicative supervision, and a conflict between multiple CCP regulators during a time of crisis. And it is these negative consequences that will ultimately lead to market fragmentation and, thus, real economic harm. This fragmentation could lead to higher costs for commercial firms for financial institutions and for their customers. And they may also limit the jurisdictions that CCPs choose to operate in, thus reducing the access to important markets for clearing members and the clients that they currently benefit from. And ultimately what does this result in? Again, it is a decrease in liquidity that is needed for the well-functioning and safe markets that we have today.

MS. MESA: Just to finish this up with the timeline, currently EMIR 2.2 actually can't become applicable until these requirements or regulatory requirements level 2 are complete. Level 1, which is the legislation, is not yet published in the official journal, which it has to be before level 2 is then issued. We expect that to come before the end of the year.

Once that is done, ESMA will issue its technical advice, which is what we are consulting on right now, to the European Commission on EMIR 2.2. We think that will -- the three of us, by the way, in creating this timeline not only looked at what was in the consultation and what has been said publicly but the information that we have been gathering. So this is our own, a little bit of our own, intel.

We think that ESMA probably will issue technical advice again before the end of the year right after that is published in the official journal. Then what has to happen is the European Commission issues a delegated act. And that is sort of the final step for these level 2 regulations. And the delegated act really is what will govern. They have to allow three months for the European Parliament or the European Council to object under what is called the better regulation agenda. It is a public sort of consultation, but it is really for the political bodies to weigh in. And that will probably happen end of this year, early next year.

And then determinations will start happening for non-E.U. CCPs. We think this whole process at that point could take 18 months before EMIR requirements kick in for non-E.U. CCPs, again our best estimate, made a guess on that.

Thank you.

MS. VAN DEN DAELEN: It is hard these days working at a London-based institution to not mention Brexit. So, even though Jackie just described the relevant timelines for the world as it is today, our world in the U.K. will change presumably come the 31st of October. So operating under the assumption that there is a no-deal situation -- and there could be a deal that is made, but I do not have a crystal ball. So I can't tell you that.

But operating under the assumption that there is a no-deal Brexit on the 31st of October, last year, the European Commission in conjunction with ESMA granted temporary recognition for the U.K.-based CCPs, including ICE Clear Europe. And, thus, we are allowed to offer our services into Europe until the end of March 2020. So there is a time gap between the end of October and the end of March.

However, CCPs have notice periods for termination in the event that it becomes illegal to offer our services in Europe. ICE Clear Europe has a 30 business day notice of termination if we need to cut off access to E.U. clearing members. Other clearinghouses in London have as high as a 90 calendar day termination period. So that really brings us to around mid to end of December when the CCPs will need to have clarity as to how we will operate once the temporary recognition ends at the end of March 2020. So, as you can see, that is a very short timeframe between the end of October, when the no deal happens, and then December, when we would potentially need to terminate members.

And during that timeframe, there are a few actions that can be taken. First, the European Commission and ESMA can extend our recognition and give us more time or, alternatively, we can walk through the steps that Jackie just described and complete all of these legislative steps by mid December, which I think would be trying. But, nevertheless, that is something that we hope can happen so that we have resolution and our clearing members have certainty that they can continue to use our services.

MR. DOWNEY: If I could just make one final statement, just to flip that a little bit. There is an assumption potentially that a no-deal Brexit could occur October 31st. And Carolyn laid out the timeline and implications there. Of course, on the other side of the coin, there is the possibility that it is extended for 12 months, 2 years, 3 years, whatever it may be. In that case, the end result could potentially be a situation where U.S. CCPs actually are the only CCPs that are third country, at least from a size perspective, as far as we can tell, that may be subject to all of the steps that are laid out here. And so, obviously, that is potentially a perverse result from this new legislation and the ongoing political dialogue to be the U.S. being caught in a position as being non-E.U. and being subject to all of these new requirements, but no other CCPs are. And so there are kind of two potential timelines. I think both of them are negative and they could impact different jurisdictions differently.

CHAIRPERSON KARNA: Great. Thank you very much.

Do we have any questions or comments for our panelists, first in the room? Mr. Cutinho?

MR. CUTINHO: Thank you. Thank you very much. I would like to thank our panelists for an effective presentation.

I think I will be brief. There are two things. One, we have expressed our concerns with respect to the tiering. And if you look at the indicators, I think I hope what comes through based on what we see publicly is that ESMA’s technical advice deviates substantially from the spirit of the five critical factors that determine tiering. So it is important to see I think some level of certainty that any rules that are put in place is, in fact, addressing the nexus with the E.U., whether it be union currency products or members based in E.U. and the exposures that they have.

The second thing in the absence of that, we are left to assume the worst. We are left to assume that Tier 2 is what would arbitrarily be applied. And in those circumstances, our concerns, as you have noticed, as you have heard today from the panel, is about comparable compliance. And it completely disregards the equivalence agreement that is already in place. And, in fact, it presents significant conflicts and from our perspective -- I speak from a risk management perspective -- significant conflicts.

We can take two simple cases. One is individual segregation. So individual segregation cannot be offered in the United States. Our account standards are gross and legally segregated but operationally comingled. The second issue that we have is when we think of default management. So when we have managed risk in the past, we have a strong history of porting our non-defaulting clients to solvent FCMs. And we have been able to do that because our regulations in the U.S. have afforded us the flexibility of moving our clients to a safe home in the event that we face an issue like this.

Under European law, that is not possible. In fact, it requires a clearinghouse to get the explicit consent of each one of its clients and then determination as to their end destination. And we don’t think that is a workable solution.

I have just referred to two issues where it presents risks. You know, if we were to go further, our concerns would be in the ability of a clearinghouse to administer margins, so our ability to actually cover our risk exposures when we see them.

You know, today under CFTC rules, we have a great set of principles that apply not only to a clearinghouse but to our clearing firms and in the way our clearing firms administer margins when it comes to their clients. All of that is under risk when Tier 2 regulations are applied.

CHAIRPERSON KARNA: Thank you.

Commissioner Quintenz?

COMMISSIONER QUINTENZ: Yes. Thank you.

I just had a quick question for Carolyn.

Given all of the steps that need to occur regulatorily and legislatively and the window that you described from a notice period perspective, do you believe it is basically a certainty that there will need to be an extension of the exemptions to operate in the E.U.?

MS. VAN DEN DAELEN: Thank you for your question. Yes, I think it is highly likely that an extension will be needed. And we have heard recently -- and I know there have been press articles about this -- that temporary recognition could be extended, but the more time we have with that knowledge, the better, not only for the clearinghouse but also for the clearing members, because if we don’t know about this temporary recognition being extended until later in the game, then clearing members may have to take proactive steps to find another clearing house, tell their end client. So, again, while I think that it is likely and I am not certain, the more time, the better.

MS. MESA: To just elaborate on what Carolyn said, I think, even though a clearinghouse may issue a notice 90 days before termination, which would actually be in December -- so we are getting close -- clearing members do start already. They don’t wait for the notice to show up at their doorstep, but they already start planning alternatives. So the longer that goes into November, really, the scarier that becomes.

CHAIRPERSON KARNA: Mr. Horkan?

MR. HORKAN: Thank you. And I really wanted to offer my thanks for the Commission and commissioners for taking this leadership role on cross-border regulations and seeking coordination and cooperation. So thank you very much.

On behalf of LCH, which operates clearinghouses both in the E.U. and outside the E.U., it is clearly important. And as we operate the largest interstate swap clearinghouse with clients’ members in 60 jurisdictions, it is critical for us that we have clarity on the rules and regulations in the jurisdictions that we are part of, including being directly registered with the CFTC for, proudly, the last 18 years.

We submitted, our parent company, LSEG, submitted, a comment letter on July 30th that really talked about a couple of things that I think the panel members articulated and outlined today: one, on the tiering, really need clarity on the measurement against these indicators as well as the prioritization for them, as Carolyn said. And, secondly, on the comparable, I believe it should be an outcome-based approach, as opposed to a requirement-by-requirement basis. So we would definitely like to seek clarity on that and submitted the comment letter accordingly.

And to Commissioner Quintenz’s question, we do think an extension would be likely, would certainly be welcomed, both by the market to avoid fragmentation, to provide certainty to our members and clients that we will continue to offer the service that we do. And to date, we have seen no change in client behavior due to that lack of knowledge, but we would ask all regulators to eliminate any doubt.

CHAIRPERSON KARNA: Thank you.

Mr. Wetjen?

MR. WETJEN: Thanks, Angie.

I actually had a question for the panel. What is your understanding of the role of the ECB or the other European central banks at issue under EMIR 2.2?

MR. DOWNEY: Sure. I will take that. And

then feel free to expand. But the way that the EMIR 2.2 text is drafted, we understand that the ECB and other central banks of issue would have powers in emergency situations to express and require CCPs to take certain action in regard to margins, liquidity risk management, and other risk management tools. I believe those powers are designed to last for six months once they take action and then they have the ability after those six months to extend as necessary. We also understand -- and this is informally, rather than within the text, that there is an expectation that they would be able to weigh in and express their views informally. And, in addition, they are I believe observers but maybe not voting members of the supervisory colleges that are going to be constructed as part of this non-E.U. CCP construct for Tier 2 CCPs.

MS. VAN DEN DAELEN: Yes, that is correct. That is my understanding as well. And, as Sean said, the ECB does sit as a nonvoting member of our EMIR college.

MR. WETJEN: So DTCC, we actually filed a letter response to the tiering release too. We are a clearing settlement service provider for the cash markets, not derivatives markets, but one of the things we raised in our comment letter response to the release was this issue around the involvement of the central banks, both over in Europe but as well as here in the United States. I think part of the reason why we raised it was just to be very open and honest about it.

I am not sure and haven't been convinced that the central banking community in Europe has fully thought through or those who are making this policy on behalf of the central banking community in Europe have fully thought this through. And I don't know whether the European-based CCPs have a view on this, but if you designate a non-E.U. CCP as Tier 2, then, necessarily, you are going to involve not just the market regulators but the central banks of two different countries. So, in other words, we have obviously a number of SIDCOs and SIFMAs here in the United States. And if the same designation under EMIR 2.2 of Tier 2 status comes into force in the E.U., then you have a very difficult situation where you have central banks in their role as supervisors but also the providers of emergency tools and some kind of potential conflict about who is going to do what. And that is a very, very difficult position I think to put central banks in. So we all have our relationships, fondness for the CFTC and the other market regulators, but the central banks I think are a really important part of the policy-making here. And something that I am not -- I haven't been convinced it has been thought about as much as it should be, not so much on the part of the policy-makers here but obviously those making the policies, in this case EMIR 2.2 over in Europe. So I just wanted to raise that point here.

CHAIRPERSON KARNA: Thank you.

Ms. Bradbury, did you have a comment? Mr. Yamada?

MR. YAMADA: Actually, I would echo those comments. And, as we recently saw the joint CFTC-ESMA letter I guess reestablishing a more collaborative and cooperative attitude, I think that was heartening, but the practical concern is, even if we do have some clarity around what is very clearly not a clear set of restrictions with respect to who is beholden to which regimes, you can see a situation where in times of stress, you have multiple different regulators and central banks instituting somewhat conflicting policies and, frankly, that resulting in an increase, rather than a decrease, in systemic risk and a lot of conclusion and more trapped capital and more restrictions around resolving some of the issues we face with counterparty liquidity and ending up tying us up in knots a little bit. That is a little bit of a concern from our perspective because we do see a little bit of that happening. We have seen that in the past.

Again, to the extent that regulators are cooperating, trying to rationalize, and not duplicating efforts, that will do a lot to resolve that, but you can quickly see a situation where, you know, that there is gridlock because of multiple conflicting and not ill-intentioned but just conflicting requirements from different regulatory bodies, which, frankly, on a day-to-day basis have not necessarily been relevant.

CHAIRPERSON KARNA: Thank you.

Mr. Muller?

MR. MULLER: Yes. My name is Erik Muller. I am the CEO of Eurex Clearing. So I represent a CCP that is based in the E.U. And I can echo some of the points that were made here.

The CCPs operate global businesses. Our

markets are global, especially if you look into the derivatives markets. It may not be as pronounced in some of the other markets but certainly in the derivatives markets, these are global in nature. So I think it is really important that regulators globally find a way on cooperating. There needs to be global cooperation in managing these situations and the oversight.

But I think it is also worth bearing in mind that Europe, as far as I see it, has been probably going at taking that, you know, to the extreme in terms of granting equivalence. So if we as a European CCP want to do business in the U.S., there is no question you get a license for it.

And our experience with the CFTC has been a good one. And I can confirm what was said previously by LCH. So it is possible, even if there are different roles that apply in Europe, to comply with other regimes.

And I would like to counter some of the potential impression you might get from regulations in Europe from one of the previous speakers and as it regards segregation models, et cetera. I think they are just different. You know, you could make the case that individual segregation is a stronger form of segregation, especially if you look at the end clients. Then is the model available in the U.S.? But there is a background to it, and it is enshrined in the laws in the U.S. and goes to the bankruptcy regimes that are different in each of these countries.

So what I am trying to get at is there are ways to navigate these differences. And we have to find these ways. And I can only encourage both the CFTC but also the E.U. Commission to find ways that allow U.S. CCPs to continue to do business in Europe but also the European CCPs to continue to do business in the U.S., as these markets are truly global.

Thank you.

CHAIRPERSON KARNA: Thank you.

Ms. Mesa?

MS. MESA: I just want to pick up on a point on the central bank point and the numerous hands, as they say, on the steering wheel in a crisis, which can cause greater systemic concern. I think what is critical here is probably the MOU. If a CCP in a certain jurisdiction is a Tier 2 CCP, then what will happen is there will be a negotiation of an MOU. And hopefully the regulator in that third country will negotiate all of that ahead of time through an MOU.

The issue, though, is that what remains in the law in level 1 of EMIR 2.2 is a potential for a relocation. That remains. It is not being talked about anymore because there have been assurances that it won’t be used. But I think, you know, cleverly, if they are not perhaps getting what they need out of that jurisdiction and that regulator, there is always the threat that, “Well, we are just going to have to move that clearing.”

So, just to keep in the back of your minds that I think this is a huge issue. Who does have control in a crisis? And what does that look like? I think it is really important for the industry to know that ahead of time. Who are they going to answer to?

And speaking I guess on behalf of the clearing member community, if they are getting instructions, and particularly for the CCP, who might be getting different calls for different things, for the clearing member community, if they are getting different calls to do different things from different regulators, that just sounds like a nightmare. So hopefully that gets worked out.

CHAIRPERSON KARNA: Mr. Downey?

MR. DOWNEY: Thank you.

I just wanted to pick up on a couple of points as well. It is true that cooperation will be important and that hopefully we can find ways where different jurisdictions have different regulatory requirements, that those can be reconciled and that there is a path forward, but we should also remember that each jurisdiction creates a regulatory regime based on its local markets, its local legal requirements and its local banking regulations. And so an example of that would be we understand in Europe, there has been a focus on the reinvestment of cash collateral. And that is likely due to the historic depositor protection in Europe.

In the U.S., our friends, both at the CFTC and the Fed, have spent a lot more time focusing on liquidity risk management. And so the approach to collateral and approach to managing liquidity is different in the two regulatory regimes. And we think that is probably appropriate. And that is an example of where you could get to a conflict and be in a situation where you undermined stability because each regime has taken an approach that is appropriate for its overall legal regime and its regulatory regime. And we think it is important to remember that and not just assume that overlaying regulations on top of each other will create a better result.

I also just wanted to point out from the perspective of the CFTC, it is not true that if you are a non-U.S. CCP, you necessarily have to register in the entire exchange-traded derivatives market. You actually do not need to register to offer foreign futures to U.S. persons. So I just want to clarify that point because I think it might have been lost in the previous statement.

CHAIRPERSON KARNA: Mr. Cutinho?

MR. CUTINHO: Sean took some of my words away. So I will have the second point.

Erik is right. You know, individual segregation may not present financial risks to us, but I was simply pointing out that it presents a legal risk to us, so risks in general. People talk about legal and financial.

CHAIRPERSON KARNA: Commissioner Stump?

COMMISSIONER STUMP: I actually was going to ask a question about the offering of futures, but I will take it a different direction. I would like for the panel to maybe elaborate on the idea that -- because I think oftentimes people in the public are not quite as aware that the conversation over the past few years has been almost exclusively centered on OTC swaps. So the discussions we have had at the CFTC with our counterparts in various jurisdictions have been focused on OTC swaps. So to the extent that a U.S.-based CFTC-registered DCO has been offering futures in the commodity space for years, whether it is crude oil or cotton, how might that be impacted should a U.S. CCP be deemed Tier 2? And how might those particular end-users and their clearing members be impacted?

MR. DOWNEY: I can start with answering that question. So the most obvious potential impact -- and this, again, goes back to market structure and legal and regulatory regime -- is the fact that in the U.S., primarily and I think exclusively, frankly, for commodities, agriculture, and energy, there is an ability to collateralize via letters of credit. So our participants, for example, who are in the agricultural space, have the ability to deposit letters of credit to meet their collateral requirements with us because, for whatever reason, they may not be natural holders of U.S. Treasuries or U.S. dollar cash or whatever it may be.

Our view is that that has developed over a long time period. And it is very important, in particular, for the U.S. agricultural markets. And so that is probably the most obvious direct example of potential impacts on U.S. markets and on U.S. participants in the commodity space.

There are others. Any potential where you have two different regulatory regimes increases costs and makes access likely or potentially more expensive, but I think the primary potential and the most clear potential issue is in the letters of credit and the ability to use that as collateral.

MS. VAN DEN DAELEN: Another potential downstream effect on clearing members and clients could just be that with the increased supervision from a new regulator, longer lead times to implement new products and new margin models are changes to products and changes to margin models, which could potentially be not what a clearing member wants if the margin model is more efficient. So I think for that, it is something you have to consider again when you want to add a new regulator as a supervisor.

CHAIRPERSON KARNA: Another question for our panel: what kind of feedback have you been getting from your own clients around these proposals? We have heard a lot about your perspectives and potential impacts on your clients, but have you been engaging with your clients? Have they been engaged on this topic? And what kind of feedback have they given you?

MR. DOWNEY: So our engagement has primarily been at the association level; so Jackie, for example, so primarily FIA and ISDA. We have engaged with both of those associations. And I think, as reflected in the comments that they provided, I think there is a recognition that regulatory cooperation, reciprocal deference is important, both for us as a CCP but also just more generally for the markets from a risk perspective and from an efficiency perspective.

So I would say over the last months in

particular, as this European process has accelerated towards a finish line, we have engaged. And our understanding is that the same areas of concern, in particular, with the ESMA consultations and the way that they have been designed I think have arisen within the market. But I defer to the market.

MS. MESA: Well, I think this is an interesting point. When we ran the working group, our working group had participation from clearing members, end-users, and CCPs and exchanges. And the working group actually was run out of Europe, not in the United States. So the main participants in the work were European. We had some Asian participants, some in the United States, but the bulk were European. So the views here in our FIA response are mainly those of European participants.

And I think the reason that they reflect a lot of the views you have heard up here is because when they think about CCP regulation, they are also thinking about clearing member, swap dealer, every other regulation that could come down the line. And the thought is we don’t want duplicative regulation anywhere, actually. If it is comparable, that should be enough.

And so the view we took in our response was how should the regime, regulatory regimes, work cross-border in every single space? And that is the view in our response.

CHAIRPERSON KARNA: Mr. Wetjen?

MR. WETJEN: I was just going to try to respond to your question 2 from a different perspective, that of the cash marketplace. You have heard from other people, though, earlier today about the appeal of having access to cleared products. And that is true on the cash side, too.

And so, just for whatever it is worth, one of the things that we have encountered or discovered is that we are actually trying to expand access to clearing as much as possible on the cash side. We are doing that through a couple of different products. We call them the sponsored member programs that we are offering to different market participants. But so long as this issue has not been fully resolved -- and we have been focusing mainly on Europe and EMIR 2.2, but there are active policy-makings in other jurisdictions as well.

So wherever this issue is unresolved, what we are finding is that either there is some reluctance on the part of the CCP or there is some reluctance on the part of these would-be members or sponsored members to the clearinghouse in participating in the program because no one quite knows what the regulatory impact would be. But we had an internal panel last week at our company, and we had a number of firms that are also represented here today. And people are talking about the importance of some of these products that I just mentioned and having access to clearing, especially for repo activity and securities financing and things of that sort. And, again, it is just harder to do that.

In fact, one of the panelists last week at our internal conference said, “We would like to see these products moved to international participants. We want more sponsored members coming in from outside the U.S.” And, again, it is difficult to do that when there is not certainty about what the regulatory and legal impact of that would be.

CHAIRPERSON KARNA: Thank you.

Ms. Van Den Daelen?

MS. VAN DEN DAELEN: Thanks.

So just going back to what Commissioner Stump alluded to is that the G20 was a commitment to review and reform the rules around OTC derivatives. And when EMIR went into effect, we saw that it included both OTC and exchange-traded derivatives. The G20 also called for global standards to be created and followed by regulators and deference to local regulators. And what we have heard as a concern from our members is that EMIR 2.2 is again a further extension away from what the G20 originally committed to.

CHAIRPERSON KARNA: Thank you.

Any comments or questions on the phone?

(No response.)

CHAIRPERSON KARNA: Wonderful. Thank you to our final panelists of the day. I also want to just take a moment before we go to some closing statements to thank, first of all, Commissioner Stump for gathering us all here today to talk about two very critical issues in a detailed way and for also initiating the idea of a subcommittee so we can continue these discussions. I want to thank the chairman, Commissioners Quintenz and Behnam for their participation today, thank Andrée for her incredible organizational skills in the midst of another big project she is working on. And thanks to the other staff who were very involved in helping to organize this day. And, finally, thank you to our panelists for participating and sharing your insights and also to our GMAC members. Your perspectives are very, very much appreciated by the Commission as they think through these important issues.

Commissioner Stump?

COMMISSIONER STUMP: I will be very brief. For anyone who has had to listen to me speak over the past year, I am sure I am beginning to sound like a broken record, but we all need to be reminded of how we got here. We have regulated futures for a very long time. We committed to reforms 10 years ago. And I think each time we have this conversation, we need to revisit what we committed to.

So in regards to this morning's conversation, the reason that uncleared margin was initiated was to ensure that the interconnectedness of institutions was addressed outside of the clearing space in the event that clearing was not appropriate or sought after and, in addition, to encourage clearing.

With regard to clearinghouses and the utility that they provide one of the key reforms was that we would encourage more clearing, we would mandate more clearing. We certainly do not want to set up a situation where regulatory impediments make that more challenging.

So, with that, I would like to thank Angie very much for her tremendous leadership. She gets to do all of the hard work when we have these meetings, and I think I benefit from just listening. So thanks so much, Angie. Thanks, Andrée. And thanks to all of the members and the panelists.

MS. GOLDSMITH: Commissioner Quintenz, do you have any closing remarks? Okay.

So thanks. I will echo everyone’s thanks. And this meeting of the GMAC is now adjourned.

(Whereupon, at 2:48 p.m., the meeting was adjourned.)