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COMMODITY FUTURES TRADING COMMISSION

GLOBAL MARKETS ADVISORY COMMITTEE MEETING

Washington, D.C.
Thursday, May 14, 2015

1 PARTICIPANTS:

2 Commission Members:

3 CHAIRMAN TIM MASSAD

4 COMMISSIONER MARK WETJEN

5 COMMISSIONER SHARON BOWEN

6 COMMISSIONER CHRISTOPHER GIANCARLO

7 Panel I: Assessing Clearinghouse Capital
8 Contributions and Stress Testing:

9 ROBERT WASSERMAN
10 Chief Counsel, Division of Clearing and Risk
11 U.S. Commodity Futures Trading Commission

12 JEFFREY C. MARQUARDT
13 Director, Bank Operations and Payment Systems
14 Board of Governors of the Federal Reserve System

15 FABRIZIO PLANTA
16 Team Leader Post-Trading
17 European Securities and Markets Authority

18 DAVID BAILEY
19 Director, Financial Market Infrastructure
20 Bank of England

21 SHUNSUKE SHIRAKAWA
22 Deputy Commissioner for International Affairs,
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Government of Japan

Panel II: Margin for Uncleared Swaps:

23 CARLENE KIM
24 Deputy General Counsel
25 U.S. Commodity Futures Trading Commission
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6 Deputy Associate Director, Division of Research
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1 P R O C E E D I N G S

2 MS. BARRETT: Good afternoon. As the
3 GMAC designated federal officer and temporary
4 chair of this committee, it is my pleasure to call
5 the 18th meeting of the Global Markets Advisory
6 Committee to order.

7 Before we get started, I just want to go
8 over a couple of things with regards to the
9 microphones. When you want to talk, please press
10 the button. And when you're finished, please
11 press the button again to turn it off. The red
12 light indicates that it is on. Please refrain
13 from putting any devices on the table, as it might
14 interfere with the audio. There are speakers
15 present on the teleconference line, so make sure
16 to speak clearly into the mic so that they can
17 hear you.

18 For those participants on the audio
19 conference line, make sure to keep your phone on
20 mute until you're ready to speak. And when you
21 are ready to speak, please make sure to identify
22 yourself beforehand.

1 For those of you in New York, the
2 microphones are a little bit different. They are
3 Polycom. Same goes for you; it's a push-to-talk
4 mic system. The light will turn green when it's
5 on, and it will be red when it's off.

6 Last thing: Please be advised that this
7 meeting is being recorded and webcast.

8 Thank you, and I'll turn it over to
9 Commissioner Wetjen.

10 COMMISSIONER WETJEN: Thank you, Dani.
11 Welcome, everyone. I want to thank everyone for
12 participating. As Dani indicated, we have some
13 participation here from New York. I see
14 Commissioner Giancarlo on the screen, and Doug,
15 and Wally, and Caitlin. So, thank you for being
16 here in New York. And thanks to those on the
17 phone. And I want to welcome Chairman Massad and
18 Commissioner Bowen, as well.

19 A special thanks to our panelists -- we
20 have some real experts here with us today from
21 around the globe. We have David Bailey, from the
22 Bank of England; Fabrizio Planta, from ESMA;

1 Shunsuke Shirakawa, from the Japanese FSA; Jeff
2 Marquardt, from the Federal Reserve; and, on the
3 later Panel, Sean Campbell, from the Federal
4 Reserve. So, thank you to all of you for being
5 with us today.

6 I want to recognize our staff, too. We
7 have several staff members from the CFTC who are
8 helping us; joining us today: Bob Wasserman,
9 who's with this panel. Later, we'll have Carlene
10 Kim and Paul Schlichting, from the CFTC. So,
11 thank you to them, as well. And thanks to the
12 logistics team and the Office of Data and
13 Technology for helping us with the
14 videoconferencing and with the phone lines. We
15 had to make some last-minute arrangements in light
16 of the train accident north of Philadelphia. So,
17 thank you to them.

18 And, last but not least, thank you to
19 the GMAC members. I appreciate all of you being
20 here today. I think we have an interesting and
21 good discussion before us. We're here to talk
22 about CCP risk management and the CFTC's cross-

1 border application of its margin rule for
2 uncleared swaps -- so two timely topics, two
3 important topics.

4 Let me just say a couple of other brief
5 remarks before I turn it over to Chairman Massad
6 and my fellow Commissioners.

7 Since the G-20 communique in 2009, the
8 CFTC and other regulators around the globe --
9 including some here -- have significantly raised
10 the standards for CCPs. This obviously made a lot
11 of sense, in light of this new market structure we
12 now have for the swap marketplace. We wanted to
13 be sure that we had adequate standards and risk
14 management practices at CCPs. And, of course,
15 there's considerable international coordination of
16 this effort, facilitated through CPMI-IOSCO and
17 other international organizations -- but a special
18 call to IOSCO in that regard.

19 Now clearinghouses registered with the
20 CFTC have enhanced financial resource and
21 liquidity requirements, as well as other risk
22 management standards, that reflect their

1 heightened role in the marketplace.

2 But as the clearing volumes have
3 increased, we need to be cognizant of the result
4 in increased concentration of risk and what that
5 means for stakeholders. To maintain consensus
6 behind the cleared market structure, it is
7 important for policymakers to provide a forum to
8 discuss the aforementioned concern, and review
9 whether further enhancements should be considered.

10 That's why today's meeting has been
11 convened. It presents us with an opportunity to
12 sharpen our thinking about whether and how to
13 further improve the cleared market structure.

14 Then lastly, global coordination on any
15 further enhancements will be critical. And that's
16 one of the reasons why I'm so grateful to David,
17 Fabrizio, and Shunsuke for being here today with
18 us.

19 Finally, we'll look later into the
20 different approaches laid out in the CFTC's
21 proposal on the cross- border application of the
22 margin rule. We had three different options that

1 we sought comment on, which is a rather novel
2 approach we took -- at least during my time here
3 -- and I want to commend again the Chairman for
4 facilitating that approach. I should note that it
5 appears as though the consensus view reflected in
6 the comment file in response to that proposal
7 seems to favor the prudential regulators'
8 approach, if for nothing else in order to make
9 sure there's harmony between the different
10 domestic regulators on their margin rules or the
11 cross-border application of their margin rules.

12 But we'd like to discuss it a little bit
13 further, as well as touch upon the appropriateness
14 of initial and variation margin for
15 inter-affiliate swaps. So, I'm anxious to hear
16 people's views on that.

17 Thank you again for being here. And
18 with that, I'll turn it over to Chairman Massad.

19 CHAIRMAN MASSAD: Well, thank you, Mark,
20 and thank you for organizing this very important
21 meeting of the GMAC. I also want to thank Dani
22 for her work as designated federal officer for the

1 GMAC -- and all of our other staff -- both those
2 who are making presentations and those who just
3 help put this event together.

4 Let me also thank all of the Advisory
5 Committee members for being here. We really
6 appreciate your attendance and involvement -- and
7 our guests. In particular, I would just want to
8 thank all of those who have traveled a long way --
9 Shunsuke, and David, and Fabrizio, we really
10 appreciate it -- of course, Jeff, you, also, but
11 you didn't have to travel quite as far. But no,
12 your presence here is really helpful to us.

13 And, you know, people often wonder or
14 ask me, you know, "What's going on in terms of
15 cross-border harmonization of swaps rules and this
16 sort of thing?" And, you know, it's meetings like
17 this, and it's the constant interaction that, you
18 know, our staffs have and we have as Commissioners
19 with our colleagues abroad, which are so
20 fundamental. So, we really appreciate you all
21 being here.

22 The topics we're taking up today are

1 obviously very critical. Clearinghouse oversight
2 is extremely important these days. You know, you
3 all have heard me talk about this in terms of what
4 we've done to-date already, in terms of
5 overhauling our rules. The Commission did that a
6 couple of years ago -- incorporating international
7 standards.

8 But the topics we're taking up today,
9 you know, are especially important. They are
10 topics that are going to get increased attention,
11 both by us and internationally, through the work
12 streams going on, with CPMI-IOSCO and the FSB.
13 So, I'm just delighted that Commissioner Wetjen
14 has organized this. I think it's extremely
15 important that we get some input and have a
16 discussion on standards for stress testing, as
17 well as capital needs. On capital needs I think,
18 you know, many of the issues, as we all know,
19 pertain to, what, really, does the function of
20 that capital play? Is it really an alignment of
21 incentives issue, and how do we ensure there is an
22 alignment of incentives between the clearinghouse

1 and clearing members? And how do we think about
2 that capital in the context of recovery planning
3 and the recovery process? So, I look forward to
4 those discussions today.

5 On the second panel, as Commissioner
6 Wetjen noted, we have put out an ANPR on the
7 cross-border application of our margin rule, which
8 lays out three options. We look forward to
9 talking about those today, and margin is
10 critically important. This rule is a critically
11 important piece of the overall framework, simply
12 because while we have made clearing more
13 important, there will always be a large part of
14 the market that is not cleared. We're not trying
15 to push everything into the clearinghouses. And
16 so it's very important that we have a good rule on
17 margin for uncleared swaps. And, again, the
18 international dialogue that's going on in terms of
19 trying to get our rules aligned is extremely
20 important.

21 So, I look forward to these
22 conversations. And, again, just want to thank

1 everyone for being here, and thank Commissioner
2 Wetjen again. Thanks.

3 COMMISSIONER WETJEN: Thank you,
4 Chairman. Commissioner Bowen?

5 COMMISSIONER BOWEN: Yes. Hi. Thank
6 you, and good afternoon. It's a privilege to be
7 here for my second GMAC meeting.

8 Clearinghouse, capital contributions,
9 and stress testing, as well as cross-border
10 applications of our margin requirements are
11 important issues for the functioning of our
12 markets. I want to commend Commissioner Wetjen
13 for his leadership on these issues and for holding
14 this meeting.

15 There has been a great deal of
16 discussion and debate over the last year about the
17 current state of clearinghouses, and how much skin
18 in the game should we be required to hold. In
19 fact, I recall that this issue was one of the
20 first ones that was raised during my meetings when
21 I was first sworn in as a Commissioner last
22 summer. So, I look forward to hearing from the

1 participants today on this subject, including your
2 thoughts on the costs and benefits of acquiring
3 higher capital contributions from clearinghouses.

4 I also want to note one point regarding
5 stress tests. We often hear that stress tests are
6 devised by taking past historical events, such as
7 the collapse at Lehman Brothers, and multiplying
8 the market effects by a factor of two or three.
9 Given the increased importance of clearinghouses,
10 the interconnectedness of our global markets, the
11 evolving technology, and trading strategies since
12 2008, we need to make sure that these stress tests
13 not only capture those historical past crisis, but
14 also that they are truly reflective of the change
15 realities of today's marketplace.

16 Finally, I'm looking forward to today's
17 discussion on large and unfair swaps. The
18 re-proposal of our margin rule was one of the
19 first rules I voted on as a Commissioner. I know
20 all of us want to make sure that we get this
21 right. I'm hopeful we can finalize it soon, and I
22 want to thank the Chairman for his diligent

1 efforts in that regard. Thanks so much.

2 COMMISSIONER WETJEN: Thank you,
3 Commissioner Bowen.

4 And Commissioner Giancarlo, from New
5 York?

6 COMMISSIONER GIANCARLO: Thank you,
7 Mark. I'm here with several members of GMAC who
8 could not get to Washington today. Can you hear
9 me?

10 COMMISSIONER BOWEN: Yes.

11 COMMISSIONER GIANCARLO: I couldn't get
12 to Washington today because of the tragedy on the
13 Amtrak Northeast regional train. And I think it
14 should be said, I think, on behalf of all of us on
15 the Commission and the staff, that our thoughts
16 and prayers go out to the family and friends of
17 people that were affected by that tragedy.

18 I'm very much looking forward to today's
19 hearing. And, Mark, I commend you for your
20 leadership of GMAC.

21 When the group of G-20 nations met in
22 Pittsburgh in 2009 and pledged to wholesale reform

1 of financial markets in the wake of the financial
2 crisis, their communique speaks again and again
3 about the need for coordination of global efforts
4 in the process of reg reform.

5 I think GMAC is an important element,
6 important forum in that process of trying to
7 coordinate global regulation and the reform of our
8 financial markets in the wake of that crisis.

9 And so, again, I commend you for today's
10 meeting and for your general leadership on GMAC
11 over the last several years. It does play an
12 important role, and I think today's meeting is a
13 step in that direction. So, I wish you, and the
14 Commission, and all of the GMAC members today a
15 great meeting, and I look forward to
16 participating. Thank you.

17 COMMISSIONER WETJEN: Thanks very much,
18 Chris; appreciate that. And I echo the comments
19 of Commissioner Giancarlo about the tragedy on the
20 railway a couple of days ago. Our hearts and
21 prayers do go out to the victims and their
22 families. A lot of us in this room travel that

1 way pretty frequently, and so it's hit all of us
2 in one way or another, I know.

3 Well, let's kick off the first panel. I
4 think we can do that now; right, Dani? Okay,
5 good.

6 I think what we'll do is, we'll start
7 with Bob Wasserman from the CFTC. Bob, we've
8 asked you to put together a few remarks to get the
9 discussion going. And Bob's going to share with
10 us some of his insights and a description of
11 what's underway and has been going on for a little
12 while now in the context of IOSCO, in terms of
13 further enhancements beyond standards we've
14 already put in place here at the CFTC. Bob?

15 MR. WASSERMAN: Thank you very much,
16 Commissioner. CPMI and IOSCO have been looking at
17 risk management for a number of years. And so, of
18 course, in 2012, with the principals for financial
19 market infrastructures, which are currently being
20 implemented -- but more recently, I think, we've
21 realized that it is important that, essentially,
22 the work is not done, and we have been focusing

1 for, really since last fall, on stress testing.
2 And in the past couple of months in discussions
3 with, as well, other standard-setting bodies, such
4 as BCBS and, as well, the Financial Stability
5 Board, we have been working on a fairly
6 comprehensive analysis of CCP risk, and looking
7 essentially at our current standards, and trying
8 to understand how well they can meet, essentially,
9 the future challenges that we're facing.

10 In particular, as I mentioned, we've
11 been looking very much at stress testing, and are
12 now in the process of first conducting a stock
13 tank among more than 30 CCPs, trying to understand
14 what is going on today -- what are the current
15 practices? And it's a fairly comprehensive
16 analysis -- basically, a questionnaire of about
17 100 questions, focused, really, on an analytical
18 framework which was built with the help of an
19 expert group that goes in six areas.

20 The first theme relates to governance
21 arrangements that underpin the stress testing for
22 both credit and especially liquidity risks. And

1 so in governance, you're looking at the
2 objectives, including the CCP's risk appetite, how
3 they define extreme but plausible market
4 conditions, and how these stress tests results are
5 used to inform risk management.

6 Then processes and procedures -- how are
7 the stress tests designed, executed, reviewed
8 internally -- both as to daily review of results,
9 but, as well, periodic review of the stress
10 testing framework to ensure that it continues to
11 be fit for purpose?

12 And a very critical point -- a
13 disclosure -- what are the CCP's procedures to
14 disclose their methodologies and results to
15 members, clients, and the public? And at this
16 point, I should note that the CPMI-IOSCO group has
17 had a number of interactions with industry folks,
18 including one focused on stress testing in
19 Frankfurt back in March. And I think the loudest
20 takeaway from that is the importance of disclosure
21 and governance.

22 And so there's a very strong desire, we

1 heard from the clearing members, to have some very
2 thorough disclosure of the methodologies, the
3 scenario selection, a number of other things I'm
4 going to discuss in the next few moments, with the
5 aim of being to active participants in the process
6 of the CCP's risk management. And a phrase that
7 someone said that very much resonated with me --
8 they want to be able to actively challenge the
9 assumptions and the methodologies that the CCPs
10 are using. And I take "challenge this" not as a
11 negative, but as a very positive word -- that,
12 essentially, bringing to bear their expertise --
13 and, of course, their interests in a process of
14 promoting effective and rigorous risk management.

15 The second theme covers how the CCP
16 identifies credit liquidity risks which would be
17 exposed following default of one or more members.
18 And this includes looking at the sources of such
19 risks, and those include both the positions
20 cleared, but also collateral held. They also very
21 much include liquidity risk. How such risks are
22 measured -- through a selection of risk sources in

1 a way that you can keep the problem tractable.
2 And how the exposures are aggregated -- such as,
3 for instance, across accounts or clearing
4 services.

5 The third theme explores, then, how the
6 CCP models extreme but plausible market conditions
7 -- including both the design of stress scenarios,
8 including the period over which losses or
9 liquidity needs are measured, historical
10 scenarios, but, as well, very importantly,
11 forward-looking scenarios -- because it is,
12 indeed, very important not to simply apply what
13 has gone on in the past, but to look very much to
14 the future to see what new challenges may be
15 there, both because of new products cleared, as
16 well as changes in market conditions.

17 And then, as well, the translation of
18 those stress scenarios into discrete risk factor
19 moves -- and that is a very challenging exercise.
20 One may have very strong agreement as to what are
21 the sort of macroeconomic challenges that one may
22 face, but then it is very important -- and, I

1 think, a fairly complex exercise -- to come to a
2 how one then takes those macroeconomic factors,
3 and sees how will those, in fact, affect
4 individual contracts.

5 The fourth theme, then, examines how the
6 CCP applies the risk factor shifts to member and
7 client portfolios. And that is to produce
8 estimates of stress loss, as well as stress
9 outflows -- again, liquidity risk -- but, also, as
10 well, focusing on additional sources of risk; in
11 particular, concentration risk and basis risk.

12 And one of the things I've been hearing,
13 certainly, over the past couple of months is
14 increased concern over concentration risk and the
15 possibility that the impact of concentration is
16 more than linear because, essentially, as
17 positions become larger, they become -- not
18 correspondingly, but at a higher function -- more
19 difficult to liquidate.

20 The fifth theme considers how the CCP
21 uses estimates of stress loss and stressed outflow
22 to determine, then, its financial and liquidity

1 resource requirements, and to verify, then, that
2 it maintains adequate coverage against credit
3 liquidity risks, even in these modeled extreme but
4 plausible market conditions.

5 And the final area refers to the
6 additional analysis a CCP performs to evaluate the
7 strengths and weaknesses of its stress testing
8 framework, including sensitivity analysis and
9 reverse stress tests.

10 So, again, the idea is to look at stress
11 testing at a very, very articulated level, to get
12 deep into the weeds and to understand what folks
13 are doing now, and then, based on that, to help us
14 determine, along with the results of the stock
15 take, the results of the industry workshops that
16 we've been conducting, and, essentially, our own
17 knowledge, to then perhaps come up with additional
18 guidance. That is likely to happen through the
19 use, as well, of a public consultation before any
20 final guidance would be issued. And, obviously,
21 the guidance would then benefit from the results
22 of that public consultation.

1 COMMISSIONER WETJEN: Bob, the group
2 might appreciate knowing whether there's some
3 semblance of a timeframe that the working group is
4 operating under, particularly if there might be
5 the involvement of a consultation process. Can
6 you give us a sense of that?

7 MR. WASSERMAN: So, it is -- I should
8 note I'm very much under the control of others in
9 the group, in terms -- and certainly should not be
10 taken -- yes, I have many bosses in this context.
11 I think there is a goal to perhaps do a public
12 consultation as early as possible in 2016. Again,
13 we are feeling very much the need to proceed with
14 dispatch, and are working very hard. Indeed, I
15 just came back from a meeting in New York. I
16 happily was successful in getting back here.

17 But on the other hand, need to take the
18 time to make sure that we get it right. And so
19 that's, I think, where we are.

20 As I've noted, from the perspective of
21 the CCPs, they are actually, as we speak, in the
22 middle of filling out the survey that we sent on

1 stress testing. There are other surveys that are
2 likely to go out as early as possible in the
3 summer, and that is, as well, going to feed into
4 the work that the group is doing.

5 I should note before I turn over that
6 there is another related group. So, CPMI-IOSCO
7 has a policy standing group which is doing the
8 work here. And, indeed, a number of my colleagues
9 here on the panel are part of that, as well, and
10 have been contributing very strongly to the work.

11 In addition -- and we work under the
12 guidance of a steering group -- other members of
13 the panel on that -- but, as well, there is an
14 implementation monitoring standing group. And
15 that group has been working first at a number of
16 levels to look at the implementation of the PFMIs.
17 And so there have been a number of reports already
18 published at level one, which is essentially a
19 self-assessment by the various authorities of
20 their progress.

21 There have been reports that were
22 published at the end of February, at level two,

1 for the U.S., Japan, and the E.U., with respect to
2 essentially looking at the detailed rules, and a
3 very close matching of the statutes and
4 regulations in each of the jurisdictions against
5 the PFMI.

6 Relevant here, the group is going to be
7 working at level three, looking at a sample of
8 individual CCPS -- and, in particular, focusing on
9 the issue of risk management, including, very
10 importantly, stress testing. And that group, in
11 addition to working through conducting basically
12 initial-level questions, is then likely to take
13 the answers to those questions, follow up probably
14 some degree of direct interaction. And so that is
15 a very detailed essentially analysis that will be
16 taking place of a smaller sample of CCPs to see
17 how they're implementing risk management in
18 general -- and stress testing in particular.

19 COMMISSIONER WETJEN: Thank you, Bob.
20 Next, we'll turn to Jeff, from the Federal
21 Reserve.

22 MR. MARQUARDT: Thank you, Commissioner.

1 Just a quick caveat -- I'm speaking in my own
2 capacity, not for the Federal Reserve Board or any
3 specific governor. Having said that, I've been
4 involved in this work for a long time.

5 So, let me just start with my top line
6 message, I think, right now, without front-running
7 the very important work that Bob is describing.

8 I think I would encourage very strong,
9 in-depth work on this topic -- on credit stress
10 testing and, as Bob emphasized, liquidity stress
11 testing -- which is really a bit new for some CCPs
12 and financial market infrastructures.

13 Second, we really need to encourage the
14 collaboration that Bob described between the
15 regulators and the CCPs, but bringing in, also,
16 the clearing members, the banking organizations,
17 the buy side. I think that's been very fruitful
18 so far, and I really strongly encourage the
19 continuation.

20 And I guess where I would come out on --
21 again, not front-running, but I believe that the
22 Committee should produce a very strong document,

1 and should substantially move the dial on stress
2 testing. I think that's expected, and I think we
3 need to anticipate that that will happen.

4 Now let me just make five sort of
5 general points; two background.

6 One is, the new international standards
7 actually already have quite a bit of detail on
8 stress testing -- frequencies, daily, monthly,
9 annual, governance arrangements. So, there's
10 quite a bit there, but I think we all would
11 conclude that there needs to be more granularity,
12 and, therefore, this work is needed. That was
13 actually known -- I think came out in the
14 consultation at the international level with the
15 principals themselves. There just is a matter of
16 priorities -- that not everything could be done at
17 one time. So, now we need to finish the job on
18 stress testing.

19 Second background point is just to
20 emphasize the point that the Commissioner has
21 made. Not only do we have mandatory clearing
22 coming in, but we also have increasing voluntary

1 clearing, central clearing. And as that theme has
2 taken hold -- and, secondly, as regulators and the
3 industry have opened up issues of recovery and
4 resolution -- what are the long tail -- in the
5 long waterfall, in default or liquidity -- who
6 does take losses or absorb liquidity risks far out
7 in the tail? As those issues have been opened up
8 because CCPs have become important now -- or much
9 more important -- then the clearing members and
10 banking organizations on buy side are asking
11 themselves sort of with new transparency, what are
12 my risks, and how can I control them? And they
13 are noting that on their list of counterparties,
14 CCPs are very high on that list.

15 So, these issues we're talking about
16 have become very urgent for the banking industry
17 -- perhaps unlike 20 years ago.

18 So, let me just finish out with three
19 sets of points. My third one here would be just
20 to throw out the idea, we should have objectives
21 for what we're trying to accomplish in this with
22 additional work on stress testing. I'll just give

1 you a few of mine, but others -- I just really
2 want to tee that up for discussion. I think we
3 need to, one, improve CCPs' own stress testing
4 methodologies and strengthen the organizations. I
5 think there's a lot of variation across these
6 organizations in what they do, how much they do,
7 how robust are the scenarios; we need to work on
8 that.

9 Second, we need to enable comparisons of
10 risk and strength across CCPs.

11 Third, we need to use this opportunity
12 for greater transparency -- and not just to the
13 primary regulator, but there are a large number of
14 regulators interested in these organizations.
15 Some are securities and derivatives regulators,
16 but the banking supervisors and others -- and the
17 general public. So, there's a transparency
18 dimension.

19 Fourth, comparison not just across CCPs
20 within a single jurisdiction, but also across
21 jurisdictions -- because, as everyone notes, it's
22 a global market, and the clearing members are

1 picking and choosing -- or using multiple CCPs --
2 and they need to know how strong CCP A is versus
3 B, and this is one method for sort of baselining
4 that.

5 And finally, I think there's an element
6 of helping the clearing members understand their
7 risks when they participate in multiple
8 institutions, and some of the bigger banking
9 organizations participate in many, many CCPs.

10 So, my fourth point is, we need more
11 work. I think Bob described the agenda, so I
12 won't go into that. But, obviously, there are a
13 lot of technical issues here that people need to
14 work on -- both the regulators and, I think, the
15 papers from the industry are helping, too, so I
16 encourage more of that.

17 And finally, responsive to some of the
18 questions on those, what should be the form of the
19 new standards or guidance? Again, I'm pushing the
20 envelope in a personal capacity, but I think we
21 should be open to some form of minimum
22 international standards, not just voluntary

1 guidance. We're in a voluntary world now, and I
2 think people are looking for something more than
3 the current state -- or just simply a set of best
4 practices, as helpful as those could be. So, I
5 think we should be open to that kind of thing.

6 And the alternatives are probably
7 distortions, and risk, and competition, probably
8 reduced confidence in the CCPs, and even impacts
9 on financial stability. So, that's my instinct
10 right now.

11 And the second part of this -- I think
12 the press raises this issue of a standardized
13 jurisdiction-level stress test for all CCPs. And
14 we may talk some more about that. I think we
15 should seriously consider the advantages and the
16 disadvantages of something like that standardized
17 stress test at the jurisdictional level. And I
18 think we also have a challenge at the
19 international level. We should consider some form
20 of cooperation among regulators -- so how they
21 could be more coordinated at the international
22 level, in terms of stress scenarios, and output,

1 and transparency issues.

2 So, with that, I hope that's a little
3 bit provocative, but I wanted to lean forward a
4 little bit for everyone today.

5 COMMISSIONER WETJEN: Thank you, Jeff.
6 Next, let's turn it over to Fabrizio. Fabrizio,
7 welcome. Thanks for being here. Many Europeans
8 are celebrating a holiday, I think, today, as I
9 understand it -- so appreciate the extra effort to
10 be here with us.

11 MR. PLANTA: Thank you. It's a great
12 honor to be here and representing the European
13 views. It's the second time for me to represent
14 the Europeans in this important committee.

15 So, the two issues that you wanted to
16 focus on in this panel were whether there should
17 be common standards, and whether there should be
18 more transparency. And I think that the simple
19 answer to those two questions are yes and yes, as
20 also the previous panelist has already confirmed.

21 In Europe, we decided three years ago
22 that we needed common standards on the stress

1 test. David and I worked on these standards.
2 David actually chaired the taskforce that
3 developed those. And we are very encouraged by
4 the fact that, at the international level, we are
5 now moving into a more granular definition of
6 common stress test requirements/standards --
7 certainly not best practices or guidance, as Jeff
8 mentioned.

9 What our standard covers -- so we cover
10 both the stress test and sensitivity analysis. We
11 cover stress testing procedures, so that includes
12 both historical and hypothetical scenarios. We
13 define specific risk factors that needed to be
14 tested, and we specified that the stress testing
15 should cover both the financial resources and
16 liquidity resources. And we also have
17 requirements for reversed stress tests. On top of
18 these, we have developed, also, disclosure
19 framework.

20 So, in our view, the real question is
21 not whether there should be common standards, but
22 what these common standards should cover. And we

1 think that the European framework is already a
2 good basis for this, and it's also allowing ESMA
3 to develop the standardized E.U.-wide stress test
4 that Jeff mentioned. Indeed, it is a challenging
5 exercise that we are currently running. We are in
6 the middle of that process, but, certainly,
7 without common standards, we couldn't probably not
8 even started that work.

9 So, we are, again, very encouraged by
10 the work at the international level. We are ready
11 to revise our standard if something more granular
12 comes out of this work, and we certainly believe
13 that this is the way forward -- the principle way.
14 I've always argued that there were (211) for
15 ensuring consistent standards globally.

16 COMMISSIONER WETJEN: Thank you,
17 Fabrizio. I'll turn next to David, from the Bank
18 of England.

19 MR. BAILEY: Thank you very much, and
20 for inviting me to participate in these important
21 discussions on the topic of CCP resilience.

22 We've already heard that regulatory

1 initiatives driven by the G-20 have significantly
2 increased the role and importance of CCPs in
3 financial markets. Indeed, I've heard CCPs
4 described as super systemic on a number of
5 occasions. And I think it's right, therefore,
6 that we should constantly challenge the CCP
7 community and our expectations of them. And by
8 "our expectations," I mean those of regulators,
9 users, and other stakeholders -- to ensure the
10 robustness of a CCP's risk management, and ensure
11 that their resilience meets standards commensurate
12 with their systemic importance.

13 Put simply, these are areas in which our
14 analysis and thinking should continue to evolve --
15 which is a point that the FSB has picked up.

16 I think it's also important to note,
17 though, that it's clear the international
18 community has made very significant and tangible
19 progress in enhancing the resilience of CCPs. The
20 CPMI-IOSCO principles and their implementation
21 via, for example, Dodd-Frank in the U.S., EMIR in
22 the EU, significantly raise the bar for FMIs,

1 including CCPs. And therefore, it's from that
2 strong and solid base that we should now build and
3 enhance our thinking.

4 So, turning more specifically to stress
5 testing -- as we've already heard, it sits at the
6 heart of a clearinghouse's risk management, and
7 its use is embedded within the PFMI. It's common
8 practice for CCPs to use stress testing to size
9 their default funds, to size their liquidity
10 resources, and, also, to inform wider risk
11 management decisions. So, therefore, from our
12 perspective, verifying that a CCP's stress testing
13 framework is robust is, therefore, crucial to
14 assessing its resilience.

15 And whilst the PFMI-embedded reliance on
16 stress testing -- as Jeff has already said, they
17 don't include the complete detail on how the
18 testing should be carried out. This in part
19 reflects the very nature of the services that CCPs
20 provide, and stress testing should absolutely be
21 tailored to the particular markets cleared by any
22 one CCP. But it does make it more complex for

1 regulators and users of CCPs to compare the
2 testing framework of one CCP with that of another
3 -- and, therefore, the resilience of one CCP
4 versus another -- and verify that the appropriate
5 standards are being met, and that there's a level
6 playing field between CCPs.

7 So, as a result, we've been vocal
8 supporters of CPMI-IOSCO taking forward further
9 analysis on stress testing. And that's an
10 initiative, as Bob has already highlighted, I'm
11 personally heavily involved in.

12 Bob sort of outlined the process that's
13 going on and the areas that that will be looking
14 at. And I think it's vitally important that that
15 work is taken forward and proposals are put
16 forward in 2016. But given the work is only in
17 its formative stages, it's too early to say
18 exactly what measures are needed. But I think
19 it's right that we consider additional guidance
20 and additional granularity in all of the separate
21 areas of the analytical framework that Bob
22 mentioned. And I won't go through and repeat

1 those.

2 But I also think that the work should,
3 as Jeff has briefly highlighted, the work should
4 assess the feasibility in use of standardized
5 stress testing of CCPs, similar to the testing
6 that already exists in the banking world.

7 There's real challenges that exist here,
8 not the least given the diversity of clearing
9 services and CCP business models, but a concept
10 should be strongly considered -- but as a
11 supplement to a CCP's own bespoke stress tests. I
12 think taken forward, it would be an important way
13 of providing more transparency and comparability
14 across the clearinghouse community.

15 And that brings me to the final point of
16 my comments -- which is that effective stress
17 testing is important to all stakeholders in a CCP,
18 who will all benefit from robust and resilient
19 CCPs. The clearinghouses themselves obviously own
20 the process. Regulators have a key role to play
21 in enforcing our requirements, but a crucial part
22 must be played by the users, by risk committees,

1 and directly with the CCPs.

2 Here, again, CPMI-IOSCO has played a
3 leading role in enhancing the level of
4 transparency that will be provided by CCPs through
5 disclosure frameworks for both qualitative and
6 quantitative aspects of a CCP's framework. And
7 it's now incumbent on users to make the most of
8 these and play an active role in a CCP's risk
9 governance.

10 I for one won't look very favorably on
11 users who don't actively seek to address any
12 concerns they have with the CCPs directly. And
13 it's therefore critically important that users
14 engage fully and frankly with the CPMI-IOSCO work,
15 as well as the CCPs, to ensure that information
16 requirements are understood, and that users have
17 the ability to make their voice heard at the CCP,
18 in terms of its risk management framework.

19 So, briefly, a four-point summary of my
20 comments would be that the stress testing plays a
21 crucial role in the CCP's risk management, and is
22 crucial for a CCP's resilience.

1 The international community has made
2 much progress in terms of raising the bar, in
3 terms of risk management standards. But it's
4 right that we constantly challenge CCP practice in
5 this area. That's exactly what CPMI-IOSCO are
6 doing, and we fully support that work.

7 And finally, users have got a crucial
8 part to play in helping set the right expectations
9 in holding CCPs to meet them.

10 So, thank you, and I look forward to
11 some questions later from the committee.

12 COMMISSIONER WETJEN: Thank you very
13 much, David. Shunsuke?

14 MR. SHIRAKAWA: Thank you very much for
15 giving me an opportunity to attend this Committee,
16 and to present our views on extremely important
17 topics regarding CCPs' resilience.

18 I'd like to make comments from the
19 viewpoints of authorities which regulate markets
20 other than two largest markets in U.S. and E.U.

21 It appears that the concentration of
22 risks at the small number of CCPs is occurring in

1 the course of implementing central clearing
2 obligations, and the need to understand the risks
3 and to deal with systemic implications of such
4 phenomenon of risk concentration is
5 well-recognized.

6 Under the principles for financial
7 market infrastructures, each CCP is required to
8 maintain substantial financial resources and
9 liquidity using the result of stress tests based
10 on scenarios in extreme but plausible market
11 conditions. But details are not proscribed in the
12 PFMIs regarding how to implement stress testing.

13 Therefore, it is an important step for
14 international standard setters, such as
15 CPMI-IOSCO, to start discussions on this topic,
16 with a view to enhancing transparency to market
17 participants and comparability among CCPs.

18 If these goals are achieved from the
19 standpoints of forced authority of a global CCP
20 operating across jurisdictions, it can be
21 justified to defer to its home authorities,
22 regulatory, and supervisory framework. And we can

1 avoid unnecessary overlaps and conflicts of
2 regulations between home and hostile authorities.

3 However, the CCPs, which truly need such
4 international discussions, are limited to those
5 operating globally, and considered systemically
6 important in multiple jurisdictions.

7 CCPs operating almost uniquely in
8 domestic markets, such as in Asia, to respond to
9 local needs, are quite often still in the startup
10 stage in their markets, and have fewer resources
11 to cope with various challenges while they pose
12 limited systemic risks, at least for the time
13 being.

14 If we stick to applying uniform
15 standards to all CCPs for the sake of a level
16 playing field, it becomes difficult for an
17 authority to take into account characteristics of
18 each market or each product. Accordingly, this
19 approach might pose serious impediments to new
20 entrants or development of local CCPs, and thus
21 might lead to oligarchy of clearing markets by a
22 handful of global CCPs.

1 Therefore, it is essentially to conduct
2 fact- finding exercise first, covering not only
3 global CCPs, but, also, local CCPs in order to
4 understand the differences in market conditions
5 and in risk management practices. Then we should
6 avoid a one-size-fits-all approach, and discuss
7 how to strengthen stress testing by focusing on
8 global CCPs, which are systemically important in
9 multiple jurisdictions, while trying to establish
10 a more flexible framework for the other CCPs.

11 With regard to the PFMIIs, I would argue
12 against trying to make hasty changes, and thereby
13 making them a moving target -- particularly for
14 local CCPs. The PFMIIs were compiled in 2012, and
15 many jurisdictions are now in the process of their
16 implementation. Raising the hurdles for local
17 CCPs and these jurisdictions could disadvantage
18 them disproportionately. While I accept that
19 there are some areas in which the principles lack
20 granularity, they reflect material differences in
21 rules and regulations of major jurisdictions.
22 Therefore, even if we come to the conclusions that

1 standards for stress testing need to be improved,
2 we should focus on global CCPs, which are
3 systemically important in multiple jurisdictions,
4 while we apply proportionality and sequencing in
5 the proper manner to the smaller CCPs. Thank you.

6 COMMISSIONER WETJEN: Thank you very
7 much. Thanks again to all the panelists. I think
8 even from the presentations, we could see that
9 there are differing views on a number of different
10 topics, so all the more reason that we're here
11 discussing this.

12 Let me start with a first question that
13 we'll throw out to the membership. We have these
14 experts here; we should take full advantage of it,
15 and ask them as many questions as we can.

16 But related to Shunsuke's point, what's
17 the right way to go here through the process that
18 our panelists are involved with in one way or
19 other? Is the goal -- or should the goal -- be
20 more granular standards that should result in
21 standards that are actually required -- or does it
22 make more sense to pursue guidelines or to pursue

1 guidance?

2 And I think Jeff suggested that there
3 might be a pretty significant difference between
4 the two, and Shunsuke has just suggested that
5 there might be reasons to do one or the other,
6 especially in light of the different nature of
7 perhaps emerging markets -- or at least smaller
8 ones. So, I throw out that question, and
9 hopefully someone can speak to it. David?

10 MR. WEISBROD: So, thank you,
11 Commissioner Wetjen and members of the panel. We
12 would say that there should be standardized stress
13 scenarios for clearinghouses. We would organize
14 these standards based on three principles --
15 actually, those that were mentioned by Jeff. They
16 would be transparency, simplicity, and
17 comparability -- so that authorities, the public,
18 and members can make comparisons across
19 clearinghouses in different jurisdictions.

20 We would go further to suggest that the
21 specific stress test scenarios adhere to several
22 principles. And the principles, we would say,

1 would be, one, that you need to give some thought
2 to segregation of assets. So, lumping all assets
3 into a single default fund has its risks and also
4 has its impediments, in terms of doing a good
5 stress test. At a minimum, we would see three
6 pools here: Credit, rates, and equities. We
7 would see a mix of different types of stress
8 tests: Historical, hypothetical, and deep
9 correlation stress tests. And we would see the
10 stress test results being combined across all of
11 these three categories.

12 What we would suggest is that the
13 standards be -- the stress test scenarios actually
14 be published and standardized across the CCPs,
15 with the results then displayed in a particular
16 way. The results being displayed, A, by the
17 cushion, if any, that exists with the initial
18 margin, and then across into the use of the
19 mutualized default fund. And so at a glance, it
20 would be evident to users in the community as to
21 which stress tests required potentially how much
22 use of the funded default fund, stress test by

1 stress test. And we know that there are maybe
2 hundreds of these.

3 We'd also add to that the utility of
4 considering an additional stress test for the
5 auction procedure, to make sure that if it's the
6 case that you have to actually go to auction, to a
7 large extent, you can evaluate what the
8 auction-ability of the assets are, a priori, and
9 by utilizing a stress test that would enable you
10 to see how much alignment there is on the other
11 side of that trade -- and if so, whether
12 adjustments can be made through concentration risk
13 add-ons to the initial margin and so forth.

14 So, in short, we would be supporters of
15 standardized stress test scenarios, and that the
16 methodologies that we've depicted -- and we've
17 written a paper on this, which we're very proud to
18 reference, called "Stress This House," and happy
19 to distribute it to anybody who hasn't seen it.

20 COMMISSIONER WETJEN: Now David, do you
21 have a particular view on the process at IOSCO, in
22 terms of whether they should come up with

1 guidance, as opposed to perhaps some other body
2 that should come up with minimum standards?
3 Perhaps it's a distinction without a difference,
4 but I'm hearing from the panelists that there are
5 different viewpoints on that.

6 MR. WEISBROD: Well, we think that the
7 outcome should be to disclose and establish
8 standardized stress tests and an approach to
9 disclose those stress tests, along the lines of
10 what we've indicated. Yes, we think that that
11 would enable comparability. It would at least
12 further the ability for members, and the
13 authorities, and others to compare results across
14 clearinghouses.

15 COMMISSIONER WETJEN: Sunil?

16 MR. CUTINHO: Thank you. Thank you,
17 Mark. So, first, I want to start by speaking to
18 the concept. First is, let's look at, if our goal
19 is the strength of the ecosystem, the strength of
20 the financial market infrastructure, then I think
21 the framework should encompass both the CCPs and
22 the clearing members, because it's important to

1 look through the entire structure, not just the
2 CCP, but clearing members and how clients'
3 accounts are set up.

4 The second thing to take into account
5 is, when you discuss this debate about stress test
6 scenarios versus principles, the thing to take
7 into account is, standards take time to evolve.
8 Standards cannot evolve as market risks evolve.
9 So, the more effective way, we feel, is just have
10 principles -- far more granular than what they are
11 today. We agree that we are not there today. We
12 need to get to principles that are far more
13 granular than they are today. But it is very
14 important, when you consider CCP, to look at
15 market risks as they evolve.

16 So, stress testing is dynamic; it is not
17 a static thing. To give you an example, today,
18 you know, we look at the effects markets slightly
19 differently for even the G-7 currency like Swiss
20 franc. You know, that's a difference. There are
21 events such as the debt ceiling debate that took
22 place only a few years back. So, those are events

1 that occur in the market, and the market adjusts
2 its behavior to those events. It's important to
3 take that into account.

4 So, having standardized stress test
5 scenarios -- okay, you have two problems. One is,
6 you know, standards will lag behind. So, if your
7 goal is strengthening the system, then that is one
8 of your biggest weaknesses. The other is a
9 challenge we all speak to, which is the diversity
10 of the products that are being cleared and at
11 different markets. They're essentially different
12 markets.

13 So, even in the banking world, the
14 scenarios of CCAR are different from the scenarios
15 of ECB. They are not the same. So, if you can
16 look at it, they are very different. They are
17 different from the scenarios of the Bank of
18 England. So, because there are markets, and they
19 all operate in different environments, and they
20 are different -- so it's important to take that
21 into account.

22 The other thing to take into account is

1 concentration. We speak a lot about
2 concentration. Stress testing should take into
3 account concentration and the profile of the
4 accounts. So, sometimes, portfolios are
5 well-hedged, but they are still susceptible to
6 certain type of stresses. It's important that a
7 CCP stress these portfolios to find out, where do
8 they essentially break? What kind of losses will
9 they face under different conditions?

10 So, if you establish a standard stress
11 scenario -- and let's say that is the, you know,
12 way you measure the strength of a CCP -- are you
13 sure you got it right? How do you know? So, that
14 is essentially the question.

15 So, standardized stress testing is good.
16 It's good to have standard principles, far more
17 granular than where we are today, but it's
18 important for us, as a community not to lock us
19 into a situation where we end up doing the wrong
20 thing for the environment.

21 COMMISSIONER WETJEN: (inaudible) but do
22 minimum standards really do that, if what the goal

1 would be is just simply to have minimum standards?

2 MR. CUTINHO: It is your objective. So,
3 what is your objective on minimum standards? If
4 the objective of a regulatory body or in another
5 jurisdiction for a minimum standard is just to get
6 comfort that the CCP is strong, then it is not a
7 good thing.

8 If the objective of a minimum standard
9 is simply a comparison, I struggle to figure out
10 how you would compare this minimum standard,
11 because for certain CCPs, they would have products
12 that do not even reflect those stresses. They're
13 very diverse in different jurisdictions.

14 Take a CCP that is just offering a
15 product in Australia versus a CCP that is offering
16 a product over here. Australian wheat, for
17 example -- how would you define a stress test
18 that will give you a sense that they're
19 comparable? So, that's essentially the question.
20 Australian wheat market moves differently than our
21 wheat markets. There are some correlations, but
22 very different.

1 So, it's important to keep these issues
2 and to take these issues into account when having
3 a discussion about standardized stress test
4 scenarios. We are not saying that there shouldn't
5 be standardized stress test principles far
6 granular than where we are right now.

7 Now to speak about correlation,
8 decorrelation -- I think the important thing to
9 take into account there is -- how those portfolios
10 are going to be liquidated is a very important
11 factor into how you stress correlations.

12 So, there is no hard and fast rule. If
13 you come up with a hard and fast rule that says,
14 "Yes, you have three: It's just equities,
15 credits, and rates" -- we forgot asset class,
16 which is energy products and others. So, how do
17 you define those?

18 Within a given sector, there are
19 correlations that do not make sense -- or, you
20 know, should not exist. For example, the coal
21 market in the U.S. versus an electricity market in
22 Europe. So, those are the things to take into

1 account when you do correlation stress testing --
2 is, how are these products going to be liquidated,
3 factors into how you stress your correlation.

4 So, again, when designing standards, it
5 cannot be, you know, something as prescriptive as
6 saying, "These are just these three." We would
7 rather suggest principles that talk about, you
8 know, how stress testing should justify breaking
9 of correlations. Stress testing should justify
10 how they are being liquidated. So, there should
11 be some relationship.

12 Finally, I think, as I said, we have to
13 look at the entire ecosystem. If you look at an
14 end client, right, they are clearing for a
15 clearing firm. They are clearing at multiple
16 markets. The point at which they connect to
17 multiple markets is at a clearing member, right?

18 So, when you stress test and you only
19 look at a CCP, you're only looking at half the
20 picture. So, you need to look at the complete
21 picture of when you are stressing the whole --
22 when you are objective, and your goal is

1 strengthening the entire market, and strengthening
2 the infrastructure -- or improving the confidence
3 in the infrastructure -- you need to look at the
4 whole market.

5 So, I'll stop there, and I'll reserve
6 rest of my comments later.

7 COMMISSIONER WETJEN: Clinton?

8 MR. LIVELY: Thanks, Mark. Thanks for
9 arranging this important discussion today. And,
10 say, I have a question -- so whether we go to
11 standards or to guidelines, I'm curious as to the
12 enforcement mechanisms. And so I was curious --
13 where are we headed with regards to the
14 enforcements by their guidelines or standards?

15 So, David, you mentioned the users as
16 playing an important role in enforcement. What is
17 the role of the regulator in the enforcement here?

18 MR. BAILEY: So, can I make two points?
19 I'll respond to that question directly, but I
20 obviously want to just pick up Commissioner Wetjen
21 and your comment around standards versus
22 guidelines, as well. Now that I've got the

1 microphone, I'm not going to let go of it.

2 So, in terms of enforcement, our role as
3 regulators is to ensure that -- as a supervisor of
4 CCPs, my role is to make sure that a CCP is
5 adhering to the standards that we have set, and
6 taking action where it does not. And then there's
7 multiple forms that that action could take place.

8 My comments were, deliberately
9 driven-out users have an interest in CCPs. CCPs'
10 risk governance are set up in ways which allow for
11 members, users, and even -- in Europe, especially
12 -- clients of members to have a direct role in the
13 risk governance of the CCP. And we need to make
14 sure -- and we expect to see -- that those members
15 and clients take that role seriously, and actively
16 challenge the CCP.

17 This is an area we're doing a lot of
18 work on at the Bank of England, and we see quite a
19 varied practice, actually, between the types of
20 people that different users put on the Risk
21 Committee and the level of active participation
22 that they have in the process. And I think it's

1 really important that everyone is taking that role
2 seriously, because it's in everyone's interest to
3 make sure that CCPs are resilient.

4 So, we have a direct role as
5 supervisors, but I think users also have an
6 important role to play, and I would expect to see
7 users playing that role actively. So, that's my
8 response on the first point.

9 My second point -- just, Commissioner
10 Wetjen, on your comment on standards versus
11 guidelines/proportionality -- some of the comments
12 that Shirakawa-san has made -- I just wanted to
13 note that, in the PFMI, in certain aspects, there
14 is the concept of proportionality already embedded
15 in there. So, for example, you might have a
16 cover-one standard for CCPs, but a cover-two
17 standard for globally systemic important CCPs. We
18 could equally apply that framework here, if there
19 was concern that standards were going to be set at
20 a bar that became a barrier to entry -- or a
21 barrier to CCPs in some markets.

22 But I think the important thing is that

1 there is the appropriate level of granularity --
2 that it's possible for regulators, for users, and
3 for the general public to see that the
4 clearinghouses are adhering to them. So, there
5 does need to be a level of granularity that allows
6 that assessment to be made.

7 COMMISSIONER WETJEN: Bob?

8 MR. WASSERMAN: So, I should note that,
9 actually, the enforcement mechanism for the PFMIs
10 is particularly strong -- specifically, our
11 colleagues at the Basel Committee on Banking
12 Supervision have determined that in order to be a
13 QCCP -- a qualifying CCP -- and to therefore have
14 capital treatment for exposures to that CCP, be
15 treated in a reasonable fashion, as opposed to the
16 much more -- frankly punitive -- capital charges
17 that apply to exposures to CCPs that are not
18 QCCPs. You need to be held to standards that are
19 consistent with the PFMIs.

20 And as I was sort of alluding to
21 earlier, there is a fairly articulated system of
22 implementation monitoring to see that those

1 standards are, in fact, being implemented and, in
2 fact, being applied. And so I found myself, for
3 instance, in 2013, in the very odd position of
4 having CCPs coming and saying, "Could you please
5 hold us to higher standards?" Because it was,
6 frankly, quite necessary for them to be held to
7 the PFMIs.

8 And thus, I think, to the extent that
9 what we come up with -- I'm frankly less sure than
10 my colleagues how much of a distinction there
11 would be between guidance and standards, in terms
12 of a fact. It strikes me that to the extent this
13 becomes guidance for following the PFMI, it might
14 well be thought to be the case that, therefore,
15 part of that implementation monitoring structure
16 would, in future, extend to looking at how people
17 were applying that guidance.

18 And so it seems to me that, actually,
19 from the regulatory perspective, there is a very
20 strong and sort of interleaved enforcement
21 mechanism.

22 COMMISSIONER WETJEN: I think I see

1 Wally's name placard in New York.

2 MR. TURBEVILLE: Thank you. This
3 winter, I had the great pleasure to participate in
4 OFR's conference on bank stress testing and
5 resolution. And one of the things that was a
6 strong sentiment that emerged from that conference
7 was that a stress test, whatever methodology is
8 used, whatever scenario is used in a stress test,
9 you can almost be absolutely assured that that's
10 actually not something that's going to happen.

11 There's a level of complexity associated
12 with banks and also with central clearing
13 organizations that is very high. The whole point
14 of stress testing is articulated as extreme but
15 plausible conditions, which, unless somebody
16 thinks otherwise, seems to be, in all of the
17 literature, suggestive of non-historic kinds of
18 scenarios. And, certainly, it's a completely
19 nonlinear process.

20 So, when we talk about a level playing
21 field, it seems to me that if a level playing
22 field overly refers to level standards of

1 analysis, then that's not going to yield
2 comparability of different central clearing
3 organizations. Comparability of different
4 clearing organization means in their particular
5 circumstance, they're equally safe, and sound, and
6 reliable for the public, so that the standards may
7 differ a great deal.

8 But that does mean -- since there's many
9 different regimes -- that there will have to be an
10 extraordinarily strong reliance upon comparability
11 of different regulatory agencies' demands for
12 outcomes -- meaning very strong and stable
13 systems.

14 But I just wonder if we, in sort of
15 relying on or thinking that there's some clear
16 good associated with level playing fields and
17 perhaps even competition among clearinghouses, we
18 lose track of the fact that the real comparability
19 should be about the outcome -- that they are
20 equally and very securely safe and sound.

21 COMMISSIONER WETJEN: I'll try my best
22 to go in order, but I think Stephen's had his

1 placard up for a bit.

2 MR. O'CONNOR: Thank you. I was just
3 picking up on the comparison points. I think it
4 is important to be able to compare CCPs, both from
5 a user perspective and a regulatory perspective,
6 but only where it's worthwhile. So, to Sunil's
7 point, the Australian wheat CCP perhaps should be
8 given a more lenient treatment than Shirakawa-san
9 hinted at, which also goes to the proportionality
10 point raised by David.

11 But I think that for globally-important
12 systemic CCPs that trade in globally-important
13 markets -- the clearing globally-important markets
14 -- then a valid comparison by asset class would be
15 helpful to both users and regulators.

16 COMMISSIONER WETJEN: Thank you,
17 Stephen. Larry?

18 MR. THOMPSON: Thank you, Commissioner
19 Wetjen, and thank you for having us here at the
20 GMAC.

21 DTCC, of course, runs the two largest
22 CCPs in the world, for the entire equity market

1 here in the U.S., and most of the fixed-income
2 market here in the U.S. We support the
3 establishment of stress testing framework for
4 CCPs, and we welcome the opportunity to engage
5 with policymakers in its development. In fact,
6 very, very soon, we will have a whitepaper out
7 discussing all of these issues on CCPs and risks
8 to CCPs.

9 We think the key purpose of stress
10 testing for CCPs should be to fully evaluate the
11 efficient and sufficiency of each of the CCPs'
12 total loss absorption resources in light of the
13 products it clears and the market it serves.
14 Fully standardized CCP tests would provide a basis
15 for CCP comparisons only between CCPs that clear
16 substantially the same asset classes in the same
17 or very similar markets.

18 CCPs should assess the degree to which
19 standardized testing scripts may provide valuable
20 information, but should not maximize
21 standardization at the expense of genuine
22 usefulness.

1 In other words, we would agree that the
2 market should be looked at as the end results. In
3 our marketplaces that we look at at DTCC, if the
4 equity market is being stressed, you would, in
5 fact, think that the fixed-income market has
6 actually got to be not stressed. So, you would
7 have to stress them both in different ways in
8 order to get a useful result coming out of that.

9 We also believe that you've got to look
10 at the holistic view of what the marketplace is,
11 to see how fully hedged the end user is in a
12 stressful environment.

13 COMMISSIONER WETJEN: Thanks, Larry.
14 Chris?

15 MR. ALLEN: Thank you. I think the key
16 point about standardization of approach to stress
17 testing is about transparency and comparability,
18 to the extent that that is possible.

19 I think that when it comes to the
20 question of the effectiveness of standardized
21 approach, the key issue, really, is about how
22 transparent the stress testing methodologies are,

1 the defaults, the stress scenarios and so on that
2 have been used by the different CCPs are. But
3 there's a couple of things that I think are worth
4 noting there.

5 One, as a clearing member, I completely
6 agree with and endorse the view expressed by David
7 -- that there is a huge interest on the part of
8 the clearing member in understanding the way in
9 which different clearinghouses are thinking about
10 stress scenarios, risk factors that enter the
11 clearinghouse, and so on.

12 We see from examples in the banking
13 sector where it can be a very useful tool, in
14 terms of identifying risky (inaudible)
15 concentration where it allows us to respond in
16 dialogue with our regulators in a manner which
17 allows us to mitigate some of those risks, and the
18 principle, by extension, to the clearinghouses --
19 the thought would be the same.

20 But the key point here to me is about
21 transparency. There is currently a lot of opacity
22 in the way that the different clearinghouses

1 operate in terms of stress testing. Some are very
2 open; others are distinctly less so. And as a
3 significant size clearing member, we're very much
4 advocates of driving that increased transparency.

5 I think I would say, in terms of minimum
6 standards and whether or not the guidelines or
7 otherwise -- I mean, that's less of an issue to
8 the fact, instead, that we should be thinking
9 about them being dynamic. I think it's very
10 important that this capacity to respond as new
11 risk factors entering clearinghouses, as you get
12 new hypothetical stress scenarios that they could
13 be factored into whichever stress scenarios are
14 being run by the different clearinghouses.

15 But I also think that this is not about
16 being proscriptive. I think that the introduction
17 of minimum standards -- call them what you will --
18 should be not a complete replacement for
19 idiosyncratic stress testing run by individual
20 CCPs which best reflects the characteristics of
21 the portfolios and client mix that are part of
22 that CCP product's offering.

1 So, I think that standardization or a
2 degree of uniformity of standard can be helpful,
3 but only where it's a meaningful facilitator of
4 transparency and comparability.

5 CHAIRMAN MASSAD: Let me follow up on
6 some comments that have been made about both
7 transparency, as well as the extent to which we're
8 including the clearing members in the test. I
9 think, Sunil, you made this point. I want to make
10 sure I understand what that means.

11 If you apply a particular stress
12 scenario, and that suggests some cause for
13 concern, to the extent that that cause for concern
14 pertains to one or two clearing members, as
15 opposed to something across the board, what do we
16 do with that information? Is that shared with
17 another regulator? Is it part of the transparency
18 that's been made public -- or to other clearing
19 members? What do we do with that?

20 MR. CUTINHO: So, let me answer that
21 question this way: So, I think we strongly
22 support disclosures. As Chris pointed out, it's

1 important for our clearing members to know the
2 stress shortfalls that they bring for their client
3 portfolios, as well as their own proprietary
4 portfolios for the system -- and, also, the
5 scenarios that drive them. Right. That's one.

6 The second thing to take into account,
7 to address your question directly, is, the way
8 these scenarios point out the shortfalls -- and
9 those shortfalls are prefunded. So, in essence,
10 each clearing member is proportionally, as a
11 function of their shortfall, going to fund the
12 waterfall.

13 The important thing that we were
14 suggesting is that when you look at a framework
15 for stressing it, you know, when it comes to a
16 client, they're facing multiple CCPs. So, at a
17 single CCP, we stress the portfolio, and we get
18 the capital to cover it. What is important is
19 what happens at the clearing member across all
20 CCPs. So, is there enough capital there to
21 sustain the failures?

22 Because think of this as going all the

1 way from the center down. So, it comes from the
2 clearinghouse, where there are risks. The
3 clearing member firm also has clients clearing
4 through multiple CCPs, and doing some nonclearing
5 activity, as well. So, you need to stress all
6 those portfolios together, to see if the clearing
7 member can sustain the failure, as well.

8 So, as far as CCPs are concerned, our
9 visibility is limited to the risks we see -- not
10 broader than that. Of course, on a periodic
11 basis, when you do credit analysis, you do see
12 more, but not as much as in a dynamic way, where
13 stress testing has to be done, not just as a CCP
14 but throughout the system.

15 COMMISSIONER WETJEN: Well, getting into
16 more specifics, though, how would that be
17 operationalized? How would we -- or you -- get
18 that better view into the members? How would we,
19 as the regulators, be involved in that?

20 MR. CUTINHO: There are a few things.
21 Regulators are involved today -- and I can speak
22 to the U.S. -- where we share stress results and

1 stress scenarios with you. When it comes to risks
2 that are not visible to us, we expect that, as a
3 regulator, you see information from multiple CCPs.
4 So, you can see as far as a clearing member and
5 their exposure to multiple CCPs.

6 One part that we haven't talked through
7 is, what happens at the clearing member from level
8 to client stressing? So, you stress different
9 clients -- and sharing of those results.

10 There was an activity called Payment
11 Risk Committee. It's still a body that exists
12 today. There is an information-sharing mechanism
13 where clearing members can get information from us
14 on disclosures that are now being standardized
15 through CPMI-IOSCO, but the activity -- the next
16 stage for PRC was for CCPs to get information
17 outside of the risks they see. But we haven't
18 gone there yet.

19 MR. WEISBROD: So, what we're thinking
20 is really quite specific. First of all, I should
21 say that we have 10 different default funds
22 representing the array of different asset classes.

1 And so, as Larry points out, it's really quite
2 important not to smush all into a scenery of
3 equities, and you have a fixed income at the DTCC
4 -- and to cross- margin between those two would
5 provide a distorted outcome. So, the axiom has to
6 be that you need to create as many default funds
7 as you need to accurately depict and to enable the
8 comparability between one CCP and another.

9 What we're suggesting is that for every
10 single stress scenario, it be defined; each single
11 member's P&L is run through that stress scenario.
12 And you can see, for every single member, to what
13 extent the IM may cover that. So, one
14 clearinghouse may have very aggressive, if you
15 will, IM -- in which case their reliance on the
16 default fund will be lower to begin with. But
17 there will probably be -- because it is a stress
18 scenario -- some erosion, you know, that goes
19 beyond the IM.

20 And then the disclosure would include,
21 okay, what percentage of the funded default fund,
22 including the skin in the game, is utilized once

1 the IM erosion is taken into account?

2 And you can see readily, you know,
3 whether the cover two is met. And, of course, the
4 way we manage the risk is to run these stress
5 tests every single day. And when we see an
6 individual member that approaches a 45- percent
7 default fund position on any single stress test of
8 any measure, we will then immediately call for
9 initial margin. And then when the default funds
10 are reset, adjust the default fund contribution of
11 that member to address that deficiency.

12 So, all of that's done by us -- and, I'm
13 sure, other CCPs, as well. And I think that's
14 something that we would suggest can be used in the
15 market by members, and be helpful, obviously,
16 without any disclosure on names of individual
17 members, without a doubt. But that's the concept
18 that we have in mind.

19 COMMISSIONER WETJEN: I think Bob's had
20 his placard up for a bit.

21 MR. WASSERMAN: Thank you very much.
22 So, I want to distinguish between two things that

1 we're discussing here with similar-sounding words.
2 There is standards for stress testing, and there
3 are standardized stress tests. And I think it is
4 fair to say, without front-running where the group
5 that I'm with might go, that it is well possible
6 to come to agreement on standards for stress
7 testing -- in particular, in areas such as
8 transparency, where there seems to be a lot of
9 agreement around here today -- and, certainly,
10 I've heard agreement in other forums on that.
11 There might be room, I think, as well, for
12 agreement on the other factors that I was
13 discussing.

14 I think coming to an agreement for an
15 evergreen standardized stress test that would
16 operate across jurisdictions would be very
17 difficult indeed. One may agree that there are
18 certain historical scenarios that, by asset class,
19 are very appropriate things to include -- and
20 where one would say, "Wait a minute. If you don't
21 have this or that historical scenario in your
22 stress test for thus and such an asset class,

1 something is rather wrong, or you really do need
2 to meet a burden of explaining why you think it
3 isn't appropriate." So, we might have some
4 agreement around historical stress tests.

5 When one goes, however -- as
6 Commissioner Bowen mentioned -- as stress testing,
7 it's not just historical scenarios, but one must
8 include forward-looking scenarios. And it strikes
9 me that arriving at agreed-upon forward- looking
10 scenarios -- and remember, the agreement process
11 itself takes time and effort -- and so to agree
12 upon forward-looking scenarios that would be
13 evergreen for the life of a particular regulatory
14 standard would itself be very difficult.

15 I note that in the banking world, as was
16 alluded to, there are, within jurisdiction,
17 standardized stress testing regimes. There are
18 not -- and I count the E.U. as one jurisdiction
19 for these purposes -- there is not an
20 international standard for a standardized stress
21 test. And, obviously, I'm, to a certain extent,
22 under the control of Jeff here. But my

1 understanding is that the CCAR's process, which
2 the Fed runs, is a process that involves literally
3 hundreds of highly-skilled people who basically
4 are going through every year and, indeed, changing
5 scenarios every year.

6 And I think that's appropriate. I think
7 it's important that the scenarios be dynamic. The
8 challenge of doing that on an international level
9 and agreeing on an international level on a
10 standard that would work every year is, to my
11 mind, quite daunting.

12 Now one could say, "Well, look, but
13 isn't that -- even if we get some information,
14 some comparability, isn't that better than
15 nothing?" And I guess my answer is maybe, but
16 maybe not, and maybe it could be worse than
17 nothing -- because I do get concerned that if we
18 say, okay, this is the standard, and that standard
19 is not, in fact, appropriate for this year -- and
20 even perhaps less appropriate next year or the
21 year after -- all of a sudden, this standard
22 becomes -- you know, we have this concern in the

1 U.S. around education and teaching to the test.

2 And it does strike me that folks would
3 then be working to get the best result from the
4 test, which may not be the best result absolutely.
5 And thus, I get very concerned about a false sense
6 of security. Well, look, here's the number; it's
7 the objective number that everyone's agreed to, so
8 it must be right. And so that false sense of
9 security concerns me a lot.

10 Now one way to make this more tractable
11 has been suggested. Well, maybe we can isolate
12 proto-classes -- and so basically make sure that
13 each default fund is a very distinct product
14 class. And that has certain advantages from the
15 purpose of stress testing.

16 It does, I suggest, have perhaps some
17 disadvantages, as well. There are some benefits
18 to diversity. And so if you have non-correlated
19 exposures, that tends to, to my mind, build
20 resilience in the system so that, essentially --
21 and we saw this, for instance, in Lehman, where,
22 you know, again, the question was not, how far

1 into the default fund have we gotten -- but
2 rather, why haven't we gotten more of our margin
3 back? Why? Because there was essentially
4 de-correlation between the exposures.

5 And so I do think there is a lot of work
6 and a lot of positive results to be gained from
7 gaining standards for stress testing -- and, in
8 particular, around the areas of transparency and
9 governance, but, as well, in these other areas
10 that I was discussing.

11 I am a little bit more concerned about
12 where we might go in terms of standardized stress
13 tests.

14 COMMISSIONER WETJEN: This is a little
15 out of order, but let's turn to Commissioner
16 Bowen.

17 COMMISSIONER BOWEN: So, Bob, thanks for
18 using the word "governance" twice, because my
19 question really relates to it. And you mentioned
20 at the onset that the two words you heard the most
21 was -- the two words were "disclosure" and
22 "governance."

1 Why wouldn't you have governance as part
2 of your standard, in terms of who conducts the
3 tests? What's the accountability? What's the
4 membership look like? What's independence? Why
5 wouldn't that be part of your standards? What
6 would that look like?

7 MR. WASSERMAN: And to be clear, I'm a
8 little bit reluctant to say what that standard
9 ultimately would look like, and I'm certainly not
10 saying what it would not look like.

11 COMMISSIONER BOWEN: Then David can
12 answer the question.

13 MR. BAILEY: Did I not duck at the right
14 moment there? There we are.

15 So, I think governance is an incredibly
16 important part of the stress testing process. And
17 as Bob has already highlighted in his opening
18 remarks, it's one of the areas that CPMI-IOSCO are
19 looking at. And I think it's really important, as
20 I was stressing earlier, that there is the
21 opportunity for a wide range of users -- and to
22 input into the stress testing process, both in

1 terms of the development of the tests and having
2 sight over the outcome over the tests.

3 And our role as supervisors will be to
4 look at that process and make sure it adheres to
5 the standards. So, I think CPMI-IOSCO, as it
6 already is, should think about governance as part
7 of its work. It's too early to say yet what the
8 outcomes will look like, but it should absolutely
9 consider, as part of that work, whether there is
10 additional guidance needed in the area of
11 governance around the stress testing framework --
12 and, specifically, the level of transparency and
13 input that users have into the CCP's own
14 processes.

15 COMMISSIONER WETJEN: Let's turn to
16 Jeff. You've had your card up for a while -- and
17 then Thomas.

18 MR. MARQUARDT: Thanks, Commissioner. I
19 just wanted to stress a couple of points. One is,
20 despite the debate around the table on, as Bob
21 very articulately described, standardized stress
22 tests -- which is a single scenario or a set of

1 scenarios applied across the stressed institutions
2 -- that's where the debate tends to focus.

3 And I just want to go back and say, I
4 think there's a great deal of consensus that there
5 needs to be improvements in the methodology that's
6 provided, either as guidance or as methodological
7 standards, for individual CCP stress testing.

8 Sunil probably goes a little more toward
9 principles in the guidance; I would go more toward
10 standardized methodological elements, and we could
11 define what we meant there.

12 I think there's a large amount of
13 agreement that there just is an opportunity to
14 make improvements for the industry. So, that
15 should not be lost in the debate over standardized
16 stress tests.

17 In my remarks, I was talking about
18 standardized stress tests at the jurisdiction
19 level, and part of that comes out of the banking
20 experience, and I think the number of employees
21 needed to conduct these things is quite a bit
22 lower for CCPs than for large banks who have very

1 complex portfolios, and the stress scenarios are
2 very complicated.

3 I just want to ask people to seriously
4 consider these with an open mind. We tend to hear
5 all the "why it's impossible," but people used to
6 say it's impossible to do stress tests for banks.
7 And I think, you know, that's been a remarkable
8 tool to strengthen the U.S. financial system and
9 other financial systems since the crisis, and we
10 ought to think about that. There are definitely
11 disadvantages, and those have been noted.

12 But someone ought to put on the table --
13 and hopefully the international group will study
14 this -- what would it look like? What could we
15 do? What could we accomplish with this -- not to
16 replace this methodological material for
17 individual clearinghouses, but as a supplement
18 with its limitation? Let's put something on the
19 table and discuss it -- because the theoretical
20 debate will go on, and I think we owe it to
21 ourselves, and I think the banking industry,
22 coming out of their experience says, "At least

1 let's take a look at that."

2 So, that would be my plea to everyone in
3 the room.

4 COMMISSIONER WETJEN: Thomas, and then
5 Fabrizio.

6 MR. BOOK: Yeah, thank you very much,
7 and I would like to speak briefly to the question
8 of Chairman Massad and Commissioner Bowen.

9 And I think there were three terms in
10 this debate that are very relevant. And one was
11 mentioned in your introduction -- there is the
12 role of incentives. I think the second topic of
13 -- and the capital ties very closely into this
14 one, and the others are certainly governance and
15 transparency. And I would just briefly remind
16 everyone, the role of the stress testing is to
17 define the guaranty fund, and the guaranty fund is
18 the mutualized component of the waterfall. So, we
19 are discussing the defaulter's component in our
20 margining debate that we are having in various
21 forums. And here, we are now discussing standards
22 for the mutualized component.

1 And let's think about the incentives.
2 So, this mutualized component is, of course, a
3 liability to clearing members, because it is
4 potentially at risk, and it is also, of course, a
5 cost component to clearing members.

6 Now what we see, I think, clearly, is
7 that the comparability is limited -- is also,
8 here, triggering this debate, and there is a good
9 reason for that, which is -- and it was mentioned
10 that the stress testing scenarios are very refined
11 across the CCPs, based on the asset classes, based
12 on the products. So, it will be a challenge to
13 define what we'll call sort of the standardized
14 stress test. And I just would like to mention
15 that.

16 The topics of forcing transparency --
17 currently, we have transparency to the clearing
18 member itself. He sees all the results. There's
19 transparency to the Risk Committee, who can
20 oversee the scenarios and the way it is done. And
21 there's, of course, full transparency to
22 regulators.

1 And then the question is, what
2 additional transparency will lead to what result?
3 And, of course, full transparency will drive
4 competition among clearinghouses, because it is a
5 factor of costs and a factor of liability. So,
6 that, I think, clearly says if we then tie also
7 into the governance -- which I believe strongly
8 has to be, first of all, with the CCP, who is in
9 charge of the risk modeling, and then with the
10 regulators.

11 There are, of course, certain conflicts
12 of interest in all of this, which I think have to
13 be very carefully thought through. So,
14 immediately, when you define, for instance,
15 "standardized scenarios," then, of course, this
16 will be the industry standard, and it will be very
17 hard to create an incentive to exceed these
18 standards.

19 So, I think there are a lot of arguments
20 that sort of speak towards a principles
21 outcome-based view on this that really defines
22 that the methodology leads to comparable results

1 that allow it to compare the buffers that CCP hold
2 -- because, in the end, this is about sort of the
3 shock- absorbing capacity that CCP's hold and I
4 would be also concerned if this would lead to
5 regional differences, because this will
6 immediately, of course, allocate risks to where
7 these standards are lower, and then the costs are
8 also in that regard.

9 So, also, if we talk later about
10 capital, these topics are very much, in my
11 perspective thought from an incentive perspective,
12 what will it trigger if we sort of change the
13 (inaudible) I very much support the work that is
14 now ongoing with what Bob Wasserman has included
15 the questionnaire to really do a fact-finding
16 mission -- what are the current practices, and
17 what is, then, the right way to sort of define
18 standards across all the CCPs that, I think, first
19 and foremost, will allow regulators to see what is
20 the stressed level that, in the end, the industry
21 can absorb from certain market moves?

22 COMMISSIONER WETJEN: Fabrizio?

1 MR. PLANTA: Yes, thank you. I want to
2 come back to the question of the standards for
3 stress tests and the standardized stress testing.
4 And I want to second what Bob said.

5 I think that we needed to proceed to the
6 first step and the first step is to define, at the
7 global level, the standard for a stress test.
8 Then you can think about having standardized
9 stress tests per jurisdiction, and then start
10 comparing what the different jurisdictions are
11 doing. And only after having done that, you can
12 start thinking about an international-wide
13 standardized stress test.

14 So, I think it's far too early to talk
15 about international standardized stress test.
16 Let's start from what we already agreed on, and
17 let's continue the work at CPMI-IOSCO, given that
18 we all agree on that.

19 COMMISSIONER WETJEN: Adam?

20 MR. COOPER: Thank you, and thank you
21 for convening us today. I thought, I very much
22 agree with Bob's points. And when he started

1 talking about teaching to the tests, I thought
2 maybe we were going to have a debate about
3 education reform -- which would've made it the
4 most interesting GMAC meeting ever.

5 I'm struck by the fact that we're kind
6 of stuck on the words. Or I think we're getting
7 beyond the question of standardization versus
8 guidelines -- because as Bob, I think, you know,
9 so eloquently put it, it's about standards. I
10 think we all agree on transparency, and then
11 comparability is very important. Maybe what we
12 should be talking about is not identicality, if
13 that's actually a word, but certainty and
14 precision, coupled with transparency, will provide
15 deep insight, and allow us not only across
16 different jurisdictions to define standards, but
17 different asset classes to define standards,
18 right?

19 And that way, I think we can capture a
20 range of different experiences, and yet have
21 certainty and insight for the marketplace as to
22 the, you know - what the stress test results in.

1 I guess the other point I'd like to
2 make, to just echo Commissioner Bowen's point
3 about governance, is, I think Sunil mentioned the
4 importance of involving the clearing members in
5 the process, and the importance of the default
6 management process in all of this exercise.

7 I just want to throw a little marker
8 down for participation by buy-side participants in
9 the default management committees, and the
10 governance of the way CCPs think about the default
11 management process.

12 COMMISSIONER WETJEN: Thank you, Adam.
13 Arthur?

14 MR. LEIZ: Thank you. Well, my nametag
15 says Goldman-Sachs. I'm representing
16 Goldman-Sachs Asset Management, so it is a
17 buy-side view. Just to piggyback on --

18 COMMISSIONER WETJEN: Duly noted.

19 MR. LEIZ: Just to piggyback on
20 transparency -- when I face a counterparty on a
21 bilateral basis, I'm able to -- I have a breadth
22 of counterparties that I can choose, and I'm able

1 to do sufficient due diligence into the risks of
2 the counterparty that I'm facing, and choose
3 certain counterparties over other counterparties.

4 In a clearing regime, I lose that direct
5 interaction, in some respects, with the CCP,
6 because I'm facing a clearing member who is acting
7 as agent on my behalf to the CCP.

8 So, while the number of ultimate
9 counterparties has decreased, I think a level of
10 transparency, of metrics that would be published
11 to market participants would be useful, because it
12 would help me determine which CCPs I'm willing to
13 face and which ones I may not be.

14 COMMISSIONER WETJEN: Mike, I was about
15 to call on you anyway. I was thinking that we
16 haven't heard in a while -- at least this
17 afternoon -- from one of the clearing members or
18 --

19 MR. DAWLEY: Yeah. Look, I think a lot
20 of great comments today. I think this a really
21 interesting topic, and I think CPMI-IOSCO has done
22 a fantastic job to-date. There's a lot more work

1 to be done.

2 Also, I'd just like to throw out some
3 positive thoughts to a fellow GMAC member, Kim
4 Taylor; wish her well.

5 But, look, I think there's a couple of
6 points I'd like to make. First of all, Thomas
7 made an interesting point around stress scenarios.
8 It's really to determine the sizing of the
9 guaranty fund. And I think the process for kind
10 of building out stress scenarios really should
11 involve clearing participants, also.

12 So, I think that's where governance
13 comes into play. I think, you know, governance
14 has got to be robust. It's got to be
15 all-encompassing, and I think there's got to be a
16 wide group of clearing members who really can
17 understand the risks associated with various asset
18 classes.

19 I also agree that standardized stress
20 testing doesn't necessarily work. I think that's
21 going to be challenging. My firm's probably a
22 member of, you know, 75 plus clearinghouses all

1 over the world, and I think it would be very
2 difficult to develop a standardized stress test --
3 which goes back to the individual clearinghouses,
4 and the risk committees, and the governance
5 structures.

6 These are the folks who really are on
7 the frontline, who need to develop the right
8 stress scenarios that match up with that
9 particular clearinghouse, and their group of
10 products, and their global footprint, and takes
11 into account all the different asset classes. So,
12 I feel that's so integral to this whole process.

13 The only other comment I would make --
14 which has been mentioned several times -- is
15 around transparency. I think we have a lot of
16 work to do there, even at the clearing member
17 level. I think clearing members do have access to
18 a lot of good data, but I think there's a lot more
19 information that we could use to help us evaluate
20 the risks of a CCP.

21 And one other comment that -- to Adam's
22 point -- I think the end users, or the clients, or

1 the clearing members are an important part of
2 this, but, at the end of the day, I think, you
3 know, their biggest risk is that, once we get to
4 the end of the waterfall, they certainly want to
5 evaluate clearinghouses to an extent -- but they
6 will sustain losses only once we get down to that
7 level, and that gets us into the whole recovery
8 and resolution conversation.

9 COMMISSIONER WETJEN: Adam, do you have
10 a response to that?

11 MR. COOPER: I'm not sure that I would
12 cede that we will sustain losses or should sustain
13 losses when it gets down to the end of the
14 waterfall.

15 COMMISSIONER WETJEN: Why don't we turn
16 to the second panel, just to try and abide by our
17 schedule? I'm sorry; Dani's reminding me, not the
18 second panel, but part B of our first panel. So,
19 the topic of the CCPs' capital contributions -- I
20 think we're sticking with the same panelists, too,
21 but it's already been addressed by a couple of the
22 others already.

1 We obviously have standards around the
2 overall financial resources of the clearinghouses.
3 And the CFTC rules have less specificity around
4 exactly how much of that should come from the CCPs
5 themselves. Maybe it might be useful to kick this
6 off -- to turn it back over to Bob and just
7 explain in a little more detail how our rules
8 work, and why we came to the policy decision that
9 is currently on the books.

10 MR. WASSERMAN: So, basically, our
11 requirements go to the total financial resources
12 that are required. And so, in other words,
13 essentially, the default fund is essentially --
14 what is the exposure, to either, based on either
15 cover-one or cover-two standard after the
16 application of the defaulter's collateral that can
17 be used in this regard?

18 I think there was less of a desire to
19 sort of go to the allocation between market actors
20 -- the CCPs on the one hand; the members on the
21 other -- who are not retail. And, indeed, even in
22 the retail case, we don't, for instance, speak of

1 how much can be charged. And so I think there was
2 a desire to avoid stepping into that negotiation.

3 What I've been hearing more generally is
4 that, you know, there are two possible uses for
5 skin in the game in this context. One is to
6 materially increase the resources that are
7 available. And so, conceivably, one could have
8 skin in the game requirements that essentially
9 would either increase the total or replace, to a
10 large extent, the contributions of the clearing
11 participants.

12 I think there's general agreement that
13 that would be, in most cases -- I understand
14 there's some exceptions for historical reasons
15 that some CCPs like in Australia -- but I think it
16 is fairly difficult to see that one can have
17 contributions that are going to be that large, to
18 have that kind of material effect. And that's
19 what I've been hearing from industry participants,
20 really, on both sides of this -- although,
21 obviously, others may disagree who are here.

22 The other is alignment of incentives,

1 and that is quite important. And so there is a
2 thought that, well, look, it is only if you have
3 skin in the game that you have an incentive there
4 to manage the risk. I think some folks would say
5 that. Others would say that there are other
6 incentives.

7 For instance, in the case of mutualized
8 clearinghouses, they are member-owned, and, thus,
9 their interests are aligned with those of their
10 members.

11 In the case of publicly-traded CCPs, one
12 might wonder what the impact would be on, say, the
13 enterprise value or the share price if one
14 suffered the kind of -- you know, not entirely
15 unprecedented, but actually in the U.S. Entirely
16 unprecedented -- failure of going into the
17 mutualized resources. The market might treat that
18 with some degree of harshness.

19 But in any event, that's where we are
20 now. It is something that is being looked at
21 internationally, and I think, obviously, it is an
22 area where there's been a lot of contributions in

1 a number of the papers that we've been seeing.
2 And I think it's a debate that is well-made here,
3 because it is something that folks are very much
4 concerned about.

5 COMMISSIONER WETJEN: Would one of our
6 other panelists like to speak to this? As I
7 understand it, there are differences in approach
8 in Europe -- and perhaps even in Japan. As I
9 said, we don't have specifics around the capital
10 contribution of the CCPs; we have the overall
11 financial resource requirement. Help us
12 understand how other jurisdictions might approach
13 this differently, and why they have done so, if
14 that's the case.

15 Fabrizio?

16 MR. PLANTA: Yes, thank you. I would
17 like to focus on three key questions on this skin
18 in the game issue. First is what it is. And
19 second, is it a good incentive, and what is the
20 proportionate level of it? What is it?

21 In our view -- and we have a requirement
22 for it -- it is a contribution to the default

1 fund, in terms of CCP capital. And this
2 contribution comes before the non-defaulting
3 clearing members' contribution. So, it basically
4 put the CCP capital ahead of the mutualized
5 resources. It is an incentive. It is not an
6 effective line of defense that would replace the
7 mutualization element that is the typical
8 characteristic of CCPs. So, I agree with Bob in
9 saying that it does not replace the mutualized
10 element, and they should not do it.

11 In our view, it's also not a recovery
12 tool, because it needs to be set ahead of the
13 prefunded resources by the non-defaulting clearing
14 members. It might be worth considering also
15 capital at the end of the default waterfall, but
16 let's call it differently -- otherwise, we will
17 not understand what we are talking about. So, for
18 us, it's the first line after the defaulting
19 clearing members' contributions margins and
20 contribution to the default fund.

21 Second question: Is it a good
22 incentive? We think that it is. We believe that

1 if the CCP and its shareholders never pay, their
2 incentive is to set to the margins and the
3 collateral requirements in the most aggressive way
4 to attract business.

5 And although CCPs -- probably many,
6 also, around the table -- will argue that risk
7 management is their main characteristic, so they
8 have an incentive to properly manage risk. The
9 truth is that the CCP compete everything. And,
10 also, the absence of an equivalence between E.U.
11 And U.S. -- that, also, Chairman Massad stressed
12 last week at the European Parliament -- I think
13 it's also driven by competitive consideration and
14 not just by prudential type of consideration.

15 So, this leads me to my last point. And
16 what is the proportionate level of the skin in the
17 game? There is no magic number. I think we set
18 it at 25 percent of the minimal capital
19 contribution. But, certainly, the appropriate
20 level would be a level that would force the CCP to
21 set its margins only based on prudential
22 considerations, rather than a competitive one.

1 And what is a prudential level of
2 margins? Well, for us, for exchanges trading
3 derivatives (inaudible) a level that requires a 99
4 confidence interval in two-day liquidation period.
5 And we know that one day is not enough; market
6 events has already determined that. And,
7 certainly, it's not enough for own business. And
8 we can debate about this for long, but if we look
9 from a CCP perspective, the gross or net is not
10 relevant, because for the CCP, it's always net.
11 Certainly, clients has other type of protection,
12 so gross is certainly better for clients.

13 But if we look only from the protection
14 of the CCP -- that the skin in the game is for
15 that, as well -- and for the protection of the
16 non-defaulting clearing members, then we need to
17 look at the margin period of risk, and we needed
18 to consider the two days.

19 COMMISSIONER WETJEN: Thank you,
20 Fabrizio. David, do you have any thoughts or
21 views you want to share?

22 MR. BAILEY: Thank you very much,

1 Commissioner Wetjen. Three quick points --
2 firstly, on sizing, it's clear skin in the game
3 should act as an incentive, but that doesn't
4 necessarily mean it will represent a substantial
5 proportion of a CCP's overall loss-absorbing
6 resources. And it should be calibrated to provide
7 the appropriate incentive.

8 Secondly, as Fabrizio has noted,
9 placement within the waterfall of a CCP's capital
10 is important. Clearly, the first resource is to
11 be used in the case of a default. It should
12 always be the defaulters' own assets -- their
13 margin and their default fund contribution. But
14 there's then a strong argument that a CCP's
15 contribution should follow straight after, before
16 any loss mutualization takes place, in order to
17 optimize the incentives.

18 And as Fabrizio has mentioned, I think
19 there is merit in considering -- and I'll stress
20 the word "considering" -- whether a second tranche
21 of capital should follow later on in the
22 waterfall, to ensure that CCPs' incentives are

1 retained throughout.

2 And finally, I just want to highlight
3 one area where I think a CCP's capital and
4 resources have to play the material role -- is in
5 covering non-default losses, which could be
6 incurred through investment or operational losses.
7 Here, a CCP's capital should be the first at risk,
8 as the parties responsible for the overall
9 management of the CCPs, but you've then got to
10 think, what happens if those are exhausted, and
11 then there is a case for non-default losses to be
12 allocated to members -- if not doing so would
13 threaten a CCP's ability to continue its critical
14 economic functions?

15 COMMISSIONER WETJEN: Shunsuke?

16 MR. SHIRAKAWA: Thank you very much.
17 The financial resources which each CCP relies on
18 first (inaudible) should be margins and default
19 funds contributed by the defaulter. Should
20 financial resources contributed by the defaulter
21 is not sufficient to cover the losses resulting
22 from the default, such a CCP would tap guaranty

1 funds contributed by surviving participants.
2 Thus, it is critical for a CCP to maintain the
3 level of margins and guaranty funds -- enough to
4 withstanding extreme but plausible market
5 conditions.

6 For CCPs creating members, or
7 beneficiaries, or services provided by the CCP,
8 they are usually in a position to be involved in
9 the CCP -- the risk management -- taking into
10 account these facts: A CCP is regarded as an
11 organization for mutual interest of clearing
12 members, and the risk of a member's default should
13 be borne, in principal, by the other members.

14 Having said that, I would like to draw
15 your attention to the fact that a CCP operator
16 itself can be a source of operational risks or
17 business risks. That's with a view to providing a
18 CCP operator with adequate incentives to conduct
19 proper risk management and to maintain prudent
20 business strategy. It is quite reasonable for an
21 authority to consider requiring a certain level of
22 skin in the game.

1 On the other hand, we should be mindful
2 of the possibility that it may rather
3 increasesystemic risks if the skin in the game put
4 excessive burden on the CCP operators in times of
5 market stress.

6 We should also take into account the
7 differences in risks embedded in each product to
8 clear and in relationship with clearing members.
9 As I already mentioned, the management structure
10 of a CCP may also affect the necessity of skin in
11 the game.

12 Against these backdrops, skin in the
13 game is not required in the current PFMI, and
14 Dave has said does not have regulatory requirement
15 on skin in the game. In fact, there can be
16 diverse views on adequate levels of skin in the
17 game, depending on the situations of each
18 jurisdiction, such as how developed) and how
19 competitive its (inaudible) derivatives markets
20 are.

21 Developing field concerns may not be so
22 relevant in local and developing markets where a

1 CCP is playing a rather public role to facilitate
2 Plain vanilla types of derivative transactions.
3 Therefore, discussed forced stress Testing -- we
4 should avoid applying a uniform regulation to all
5 the CCPs, and had better start discussions
6 focusing on global CCPs.

7 Thank you.

8 COMMISSIONER WETJEN: Thank you. Jeff,
9 you want to add something?

10 MR. MARQUARDT: I'll just add two quick
11 points, Commissioner. Well, three. First of all,
12 I've learned a new acronym in this discussion of
13 skin in the game -- it's called SIG. And so now
14 this is always about SIG, and so the -- just so --

15 COMMISSIONER WETJEN: That's good to
16 know.

17 MR. MARQUARDT: Two serious point -- and
18 not CIG; SIG -- the two serious points is -- the
19 first one is, you know, skin in the game
20 requirement was actually debated in the process of
21 developing the principles for financial market
22 infrastructures. And all I can say is, the debate

1 continues. And Bob and everyone went over the
2 different effects -- the incentive, the resources,
3 and so forth.

4 My conclusion is, there's been enough
5 further discussion about this issue that, at the
6 international level, it should be seriously
7 considered. I'm not saying it should be adopted,
8 but I think it should be given serious
9 consideration, and debate, and public comment, and
10 perhaps even at the jurisdictional level,
11 considered. Knowing this is one tool, risk
12 management tool, among many -- and, in my personal
13 opinion, governance arrangements are probably the
14 priority in making sure that risk management is
15 done well.

16 Second point -- I sort of developed two
17 common- sense financial stability points to apply
18 to proposals. And I'm sure others have other
19 ones. The first one is, there should be no
20 decrease in CCP resources and preferably an
21 increase from any of these proposals. So, if the
22 owned capital of the CCP is contributed early in

1 the default waterfall, others should not be
2 allowed to withdraw resources -- or the
3 configuration should not ultimately lead to a
4 decrease in resources. That would not help us, in
5 terms of financial stability.

6 And secondly -- and particularly -- no
7 increase in the probability of default of the CCP.
8 That default probability should not go up, and
9 preferably should go down. So, if you move a
10 fixed amount of CCP-owned capital up higher -- too
11 high in the waterfall, a large block of it -- the
12 CCP could go broke, covering clearing members
13 defaults at a higher probability than otherwise.
14 So, we need to be careful of the unintended
15 consequences of particular proposals.

16 And I'll just leave you with that. It's
17 very important, but, also, you know, we need to be
18 careful as we consider this.

19 COMMISSIONER WETJEN: Thank you, Jeff.
20 Jim?

21 MR. HILL: Thank you. I think that I
22 would agree with various aspects of what the panel

1 has said, insofar as, you know, we believe that
2 skin in the game is important. It's important to
3 incentivize the CCP to act in a prudent manner.
4 We agree that placement in the waterfall is key,
5 and above the non-defaulting members is where it
6 belongs.

7 Where I might differ, though, is whether
8 or not this needs to be mandated by regulation,
9 number one. And number two, where I certainly
10 differ is, should we have a standardized size of
11 some sort for the skin in the game piece? And I
12 think that the clearing members who have the most
13 at stake in a properly functioning clearinghouse
14 -- and a properly incentivized owner of a
15 clearinghouse -- should be able to evaluate the
16 risk management procedures and the management of
17 the CCP, and make a decision as to the appropriate
18 size of the skin in the game of the CCP owner.

19 And a regulation that simply imposes a
20 standardized size won't necessarily reflect the
21 appropriate levels at each CCP. And the money
22 comes at a cost, and that cost will be borne by

1 the clearing members and the buy side. And so
2 having an overly large skin in the game piece for
3 a clearinghouse that's otherwise well-run might
4 not be appropriate, but having a large piece of
5 skin in the game in a clearinghouse that perhaps
6 isn't run as well might be appropriate.

7 And so I think it's incumbent on
8 regulators to understand that there is no
9 one-size-fits-all, and a regulation that imposes
10 that wouldn't necessarily be appropriate, and
11 might put costs and burdens on clearing members
12 and buy side firms that aren't necessarily
13 appropriate for the level of risk in the CCP.

14 COMMISSIONER WETJEN: But how do you get
15 the view into the risk management practices of the
16 CCPs that you suggested in order to make that
17 assessment --

18 MR. HILL: Well --

19 COMMISSIONER WETJEN: -- as a member.
20 And would that be accomplished, as suggested, I
21 think, by Jeff just now, through the governance
22 structure of the CCP?

1 MR. HILL: Clearly, in order to make a
2 decision about the appropriate amount of skin in
3 the game, as a clearing member, you would need the
4 right level of transparency. And we talked about
5 stress tests and the amount of transparency
6 provided with respect to the results of the stress
7 test. And as a clearing member, as a member of
8 the Risk Committee, we have a significant amount
9 of transparency into the clearinghouse. And I
10 think on that basis, we could evaluate the
11 appropriate amount of skin in the game.

12 COMMISSIONER WETJEN: I'm trying to stay
13 in order here. Arthur, I think you were up next.

14 MR. LEIZ: So, I do think that
15 appropriate level of skin in the game properly
16 incentives clearinghouses between profitability
17 and risk management. I also would think that
18 global regulators would care about skin in the
19 game, since many of the recent regulations have
20 moved product to clearinghouses.

21 So, recently, I was looking at the skin
22 in the game for certain clearinghouses that I use,

1 and I literally laughed out loud in some respects,
2 because the levels that certain clearinghouses
3 have, you know, posed in the waterfall, I would
4 classify as de minimis versus the size of the
5 aggregate guaranty fund and the profitability that
6 they're making from that sleeve of cleared
7 product.

8 So, I would think that an appropriate
9 framework for determining appropriate skin in the
10 game would be a balance between ensuring that it's
11 sized, according to the guaranty fund,
12 appropriately. What that number is, is up for
13 debate -- and is also appropriately sized versus
14 the revenue stream that they're earning from that
15 product.

16 That being said, it needs to sting, but
17 not sting so much that it puts the clearinghouse
18 at risk if that was eaten through -- and, also,
19 not sting so much that it transfers costs to the
20 clearing members and, ultimately, to us on the buy
21 side.

22 COMMISSIONER WETJEN: Thanks, Arthur.

1 And Dani had a good point. We can't see whether
2 those on the phone might have their name placards
3 up. So, just a reminder to those who are still on
4 the phone -- if you have a comment, just speak up
5 at the appropriate time. I think Remco was next.

6 MR. LENTERMAN: Thank you. I agree with
7 a lot of what's been said. I believe that a
8 degree of skin in the game is very important in
9 aligning interests between the CCP and its
10 principal stakeholders. I think that a balance
11 has to be found there.

12 Also, I think that the amount has to be
13 material enough for the CCP so that the CCP has
14 effective risk management procedures in place, and
15 is incentivized and aligned with its principal
16 stakeholders.

17 On the other hand, I think that it
18 shouldn't be so material that it dis-incentivizes
19 the CCP from raising default margins or from
20 raising the contributions to the default funds in
21 times of stress. So, I think that that balance
22 has to be found.

1 Now I think that the E.U. has chosen in
2 this regard a more proscriptive methodology, in
3 terms of the contribution and the skin in the game
4 to the contribution to the default fund that it's
5 required. I would caution against -- generally, I
6 would caution against using proscriptive
7 regulations. And I think my experience has been
8 that sometimes it creates unintended consequences
9 and potential loopholes.

10 So, I would probably urge regulators to
11 look more at a principle-based regulatory
12 framework in this regard, covering these risk
13 methodologies.

14 COMMISSIONER WETJEN: Thank you.

15 MR. BERLIAND: Chairman, it's Richard
16 Berliand on the phone, may I present a point?

17 COMMISSIONER WETJEN: Yes. Go ahead,
18 Richard.

19 MR. BERLIAND: Just trying to be mindful
20 here of the economics of the industry at large and
21 the fact that we continue to be trying to push
22 business towards a central clearing environment,

1 but are, at the same time, ever more overhead from
2 both regulatory and from other processes that are,
3 in fact, in some cases, incenting business to go
4 the other way -- and thinking now about the
5 capital requirement that supports our industry,
6 and whether we're talking about member
7 contributions or CCP equity contributions, one of
8 the topics that is clearly being debated over the
9 course of the past two years is that contributions
10 do not necessarily have to be in the form of
11 straight equity, but, of course, insurance
12 tranches are one of the ideas that has been
13 floated quite aggressively over the past few
14 years.

15 Recognizing that cost of capital from
16 certain other industry sectors may be priced
17 differently, but equally may not be as readily
18 substitutable or readily immediately available in
19 the event of a default, I would just be interested
20 in asking for the panel's views to be shared more
21 broadly about what they think about use of
22 insurance tranche availability use indeed by the

1 CCPs, which is relevant to this topic for skin in
2 the game, but equally for the members, as well.

3 COMMISSIONER WETJEN: Any of the
4 panelists have a response?

5 MR. PLANTA: Well, in Europe, capital
6 both for the minimal and the contribution to the
7 default fund needs to meet the liquid resources.
8 So, it needs to be in liquid form. So, we are not
9 talking about immobilized capital.

10 And there is a difference, and it's
11 certainly even more immediately available than an
12 insurance. We generally don't consider insurance
13 within the waterfall. That could be, really, at
14 the end of that. We don't consider that, because
15 we want a waterfall to rely only on liquid
16 resources.

17 MR. BERLIAND: And, of course, insurance
18 does not have to be the traditional, as you say,
19 in mobile capital; it can be fully prefunded.

20 COMMISSIONER WETJEN: Bob?

21 MR. WASSERMAN: Yeah. I think the
22 concern is -- remember what we're dealing with,

1 with respect to CCPs. You need payments, in many
2 cases, on a same-day basis -- certainly within
3 perhaps a day or two as you go through the default
4 management process.

5 And so you would need a scheme where you
6 could very clearly rely on the liquidity, on the
7 very prompt availability of those funds. And so
8 insurance may not work that way, even if prefunded
9 in the sense that you would need something where,
10 really, the payment is highly -- you know, the
11 liquidity is highly reliable, as we say in the
12 PFMIs. I just have concerns about insurance in
13 that context.

14 COMMISSIONER WETJEN: Any of the
15 clearinghouses have a view on this possibility of
16 an insurance product becoming part of the resource
17 plan?

18 MR. CUTINHO: I have a few comments --
19 sort of held back for a while now.

20 So, before I get to insurance, let me
21 start with the definition of skin in the game. I
22 think -- sorry -- I have to do this. Skin in the

1 game does not just mean CCP putting capital
2 contributions in the waterfall. I liked Bob's
3 definition as CCP capital contributions in the
4 waterfall. That's exactly what it is.

5 And he also referred to the term
6 "allocation." What that means is that there is a
7 risk substitution effect taking place. So, if the
8 CCP's contribution increases, it reduces the
9 contribution of other participants in the
10 waterfall. So, that's something to remember. So,
11 it's an allocation mechanism. Sizing is the
12 stress testing we talked about. It's used to size
13 the funds. Allocation is about who contributes;
14 how do we split that fund across members and the
15 CCP?

16 We do agree. We are strong supporters
17 of the fact that CCPs must have contributions in
18 the waterfall. We also agree, in terms of
19 placement, that they should be junior or first
20 loss after the defaulter's guaranty fund. They
21 have an important incentive effect.

22 But it's very important to remember the

1 risk substitution effect. So, CCP contribution to
2 the waterfall is not skin in the game, and I think
3 Jeff rightfully pointed out in his very simple
4 principles that increasing a contribution should
5 not decrease somebody else's.

6 So, having said that, the second point
7 is, I disagree with Fabrizio from ESMA that net or
8 gross doesn't matter for a CCP. If you cannot
9 port a group of clients from one -- sorry I have
10 to do this, but I have to speak my mind -- if you
11 cannot port a client from one firm to another, the
12 next thing you do is, you liquidate the clients.
13 Liquidating clients has a market impact far bigger
14 and larger. And I'm sure my clearing member
15 friends would agree. So, it is very, very
16 important.

17 The third thing -- getting back to
18 insurance. Insurance has been used at CCPs
19 before. I don't know if a lot of folks were aware
20 of this, but I echo Bob's two things. One is
21 certainty of payment. Insurance has a claims
22 process, right, so certainty of payment is the

1 issue. The second is availability of funds. So,
2 once somebody's willing to pay you, the funds
3 being available. So, I think insurance -- we
4 don't think it's there yet.

5 And one of the interesting comments I
6 have heard in industry circles is, if these
7 insurance vehicles are not prefunded or they're
8 contingent funding, then the biggest issue is,
9 even if they are placed at the end -- let's say as
10 one of the recovery tools just before resolution
11 -- then the realization of the insurance industry
12 is, wait a minute; the entire market is down.
13 It's collapsed. How am I going to pay you?

14 So, if four or five members are not
15 worried about clearing. The rest of the world is
16 in a bad shape, so they won't be able to pay in.
17 So, a prefunded is one way to solve for that. But
18 returns on prefunded capital -- you're not saving
19 much. Investors demand higher returns.

20 And the second is certainty of payment.
21 So, those are the two things to remember. So --

22 MR. GOONE: This is David Goone from ICE

1 (inaudible). I'll echo the insurance issue. I
2 don't know if you can hear me over there. Can you
3 hear me?

4 COMMISSIONER WETJEN: Yeah, we can hear
5 you fine, David; thanks.

6 MR. GOONE: Okay. So, I'll echo the
7 insurance issue. We've had insurance before at
8 ICE Europe the insurers withdrew. But it's
9 exactly as stated before. You're going to need
10 money at a moment's notice, and the nature of
11 insurance is, you basically file a claim, and try
12 and get your money back. And sometimes, there's
13 arguing. You don't have that time. We're always
14 looking at structures. We're constantly looking
15 for insurance structures, because it would be
16 great if we could have it at a moment's notice.

17 But as of this moment, we've not yet
18 found a solution we think would completely work,
19 and we echo those comments. Really, it's the
20 immediacy of payments at a moment's notice --
21 that, just by nature of how insurance works, is
22 yet to be resolved for us.

1 But I think all the clearinghouses I
2 don't know if I speak for everyone I think all the
3 clearinghouses are not only being pitched, but
4 also been looking aggressively for this type of
5 solutions. They just don't exist completely
6 enough yet.

7 COMMISSIONER WETJEN: Steve?

8 MR. O'CONNOR: Thank you. So, on that
9 insurance point, I think there is room for an
10 insurance resource. But to echo the comments
11 already made, it has to be certain and immediate,
12 and I haven't seen a product yet that meets that
13 criteria. But I wouldn't rule it out as a source
14 of capital in the future.

15 Just picking up on something Jim said --
16 I might weave in the second part, as well, if
17 that's okay, Commissioner. I agree intellectually
18 with your position. You know, there might be a
19 tradeoff where a well-run CCP might have lower
20 skin in the game. But a badly-run CCP might make
21 bad decisions about what it thinks its skin in the
22 game should be, and make the wrong decision there,

1 and have something close to zero.

2 Coming back onto that second point,
3 harmonization -- should the rules be the same
4 globally? I think from a pragmatic perspective --
5 and looking at this through a different way -- if
6 One jurisdiction does have mandatory skin in the
7 game -- SIG -- MSIG -- mandatory skin -- sorry --
8 and another doesn't, then I think that's a
9 problem. The more international harmonization
10 between rules, the better.

11 To Adam's point -- a close second would
12 be in the previous discussion in this room between
13 (inaudible) Patrick Pearson and Gary Gensler on
14 international harmonization. That is important,
15 because without -- I think harmonization improves
16 liquidity, reduces costs, stops perverse outcomes
17 like entities shifting business to a new
18 continent.

19 And so with respect to clearing and CCP
20 capital contributions, I think it would be very
21 positive for regulators to harmonize on that
22 particular point. And failure to do that could

1 result in business migrating to other
2 jurisdictions where the bar is lower, potentially
3 -- resulting in those increased costs, fragmented
4 markets, fragmented liquidity, and possible
5 increased global systemic risk, due to what
6 effectively could be a race to the bottom.

7 COMMISSIONER WETJEN: Doug, you had your
8 name placard up there in New York. Was there
9 something you wanted to speak to?

10 MR.HEPWORTH: Sure. And thanks for
11 calling. My clients are generally much more
12 focused on the credit worthiness of the system and
13 of these markets right now, and they are
14 increasingly doing checks of that credit
15 worthiness. And to the extent that they can do
16 one credit check, that's better than two. To the
17 extent that they can do two, that's better than
18 three. So, to the extent that greater disclosure
19 of the results of the stress tests incorporates
20 the credit worthiness of the members, they would
21 appreciate that.

22 And furthermore, any insurance solution

1 would have to be in a bold support of everything
2 that's been said today -- immediate and prefunded.

3 So, this, we are engaged in a fairly
4 virtuous cycle now where there's an arms race
5 towards credit worthiness, and that should be
6 supported.

7 Thanks.

8 COMMISSIONER WETJEN: Thank you, Doug.
9 Thomas, and then we'll go to Fabrizio, and then
10 we'll take a break.

11 MR. BOOK: And I'll be brief, as the
12 topics were explained. But just a few comments --
13 first, on the skin in the game discussion. One
14 point that I would like to highlight, which I
15 think the European regulation captures well --
16 this is an amount that should not be tied to a
17 guaranty fund size. I think this sets a wrong
18 incentive. In European regulation, the skin in
19 the game contribution is tied to the capital of
20 the CCP, and it is significant. As soon as
21 regulation would tie it to guaranty fund size,
22 there might be the interest of reducing the size

1 of the guaranty fund to reduce the contribution.
2 So, there is certainly not a good metric.

3 I think we are seeing, with some
4 concern, that there are jurisdictions where not
5 only it is tied to the guaranty fund size, but
6 also the contribution of the CCP to its own
7 mutualized lines of defense exceeds 25 or even 50
8 percent, and one should be very aware that this
9 distorts -- or can distort -- the incentive to
10 support the DMP -- or the default management
11 process and the option process. So, I think the
12 calibration has to be set very carefully.

13 And, I mean, as initially pointed out,
14 it is an important incentive to prudent risk
15 management, but it is not something that should
16 replace the loss absorption and capacity, and, at
17 least from our perspective, the incentive works
18 (inaudible). Secondly, just a brief comment on
19 the -- probably the term "insurance" might be a
20 bit misleading in this context. From our
21 perspective, I think the important criteria for
22 contribution of the waterfall, of the prefunded

1 parts, are certainty of payment and availability
2 of liquid assets.

3 In the end, this gets down to the
4 question, could this also be done by other parties
5 in such a concept? So, if it is achieved, that
6 there is certainty of payment, and also sort of
7 prefunded availability of assets. I think this
8 should be a workable solution that does not impact
9 the incentives of the lines of defense.

10 And one last comment, if I may take the
11 liberty, just on the net margining -- we should
12 not be here, mistakenly thinking that there's just
13 net margin collected in Europe, but there is gross
14 margin collected by clearing members, allowing
15 portability. So, we are only looking here at what
16 part of this segregated pool is passed onto the
17 CCP, and that is very important, because the
18 margin is gross collected and protected at the
19 clearing member level. So, this debate is
20 probably a bit sort of not considering this.

21 COMMISSIONER WETJEN: Fabrizio?

22 MR. PLANTA: I just want to clarify my

1 point on net and gross, because we agree that,
2 certainly, clients are better-protected if there
3 are more margins at CCPs. So, on this, we
4 absolutely agree.

5 The point is that in the default
6 waterfall, the clients' margin cannot be used to
7 rescue the default of the clearing member that is
8 defaulting. And I think that we all agree on
9 this, and we should not change this.

10 So, if the on-account margins of the
11 clearing member that is defaulting is lower -- and
12 it's certainly lower if you are one day -- then
13 you more immediately affect the non-defaulting
14 clearing members. So, if you have lower margins
15 on on-account, you don't have skin in the game,
16 but this is not your case. Certainly, the effect
17 on the non-defaulting clearing members are more
18 immediate. That's what I wanted to say.

19 COMMISSIONER WETJEN: Sunil, you're
20 standing between the group and a break.

21 MR. CUTINHO: Yeah, I make it quick.
22 I'm not going to talk margin. I think I just

1 wanted to point out to a few things. I think,
2 just to react to what Stephen O'Connor just said
3 about competition, I'd be really surprised if CCPs
4 compete to reduce their contribution to the
5 waterfall. I think they'll be trying to do the
6 reverse.

7 If you look at the volume of the papers
8 out there, and if you speak to clients, they
9 really take it very seriously as to how much
10 capital a CCP contributes to the waterfall. So,
11 I'm with Jim. As long as there is complete
12 transparency into the waterfall structure and how
13 it works, clearing members and clients take this
14 very, very seriously. So, it'll work in the
15 reverse.

16 So, I don't know if regulations are
17 really necessary across the board to be exactly
18 the same. Look at it from an outcome perspective.
19 And you can make a judgment based on what you see
20 today. Independently-owned, non-
21 independently-owned, different jurisdictions --
22 look at it. I think if you do a discovery, you'll

1 realize our reality is far different from what we
2 make out to be.

3 COMMISSIONER WETJEN: It's 4:25 now. I
4 suggest we take just a 10-minute break so we can
5 get started on the second panel. I think Dani has
6 to technically break us.

7 MS. BARRETT: Okay, at this time, we
8 will take a 15-minute break or a 10-minute --
9 10-minute break. Thank you.

10 COMMISSIONER WETJEN: So, 4:35.

11 (Recess)

12 MS. BARRETT: Okay, everybody, I would
13 like to call the GMAC meeting back to order, and
14 turn to Commissioner Wetjen to introduce the
15 speakers for the second panel -- and, also, open
16 discussions thereafter about their statements.

17 COMMISSIONER WETJEN: Thank you, Dani. A
18 reminder to folks on the phone -- again, just
19 speak up at the appropriate time, when there's a
20 gap, if you have some comments you want to share.

21 I'm looking forward to this part of our
22 meeting. We're going to talk now about the margin

1 proposal for uncleared swaps. Again, we had
2 several different options - on the cross-border
3 application of the rule that we put out for
4 comment.

5 I think we'll start with Carlene, to
6 share in a little more detail what those three
7 proposals were, and then we'd love to hear from
8 Sean, from the Fed.

9 Welcome, Sean. Thanks for being with us
10 this afternoon. Perhaps Sean can share with us
11 some of the rationale and policy reasons behind
12 the approach proposed by the prudential
13 regulators.

14 But before we get to Sean, let's start
15 with Carlene. Carlene?

16 MS. KIM: Thank you, Commissioner
17 Wetjen. Let me start with the important
18 disclaimer that any views that I have shared today
19 are views of staff working on this matter, and do
20 not express the views of the Commission.

21 Last fall, the Commission published
22 proposed regulations to adopt margin rules for

1 uncleared swaps with swap dealers and major swap
2 participants that do not have a prudential
3 regulator -- which I will refer to as covered swap
4 entities -- or CSE.

5 In the proposing release, the Commission
6 also issued an advanced notice of proposed
7 rulemaking, requesting public comment on three
8 alternative approaches to the cross- border
9 application of its margin rules.

10 First, a transaction-level approach that
11 is consistent with the Commission's cross-border
12 guidance. Second, an approach proposed by the
13 prudential regulators. And third, an approach
14 which would apply margin rules at an entity level.

15 COMMISSIONER WETJEN: Carlene, could you
16 pull up the mic, please, just a little? Thanks.

17 MS. KIM: Oh, sorry. Can you hear me
18 better? Okay. The starting point for analysis is
19 Section 4s.(e) of the Commodity Exchange Act,
20 which provides that the margin rules must first
21 help ensure the safety and soundness of CSEs, and,
22 second, the appropriate further risk associated

1 with the uncleared swaps that they hold.

2 In enacting this provision, Congress
3 recognized that the safety and soundness of CSEs
4 is critical to ensuring the safety and stability
5 of the U.S. financial system. Margin serves as a
6 first line of defense to protect the CSE firm as a
7 whole, in the event of a default by a
8 counterparty. In addition, margin functions as a
9 critical risk management tool by limiting the
10 amount of leverage that a CSE can incur.

11 In granting the Commission new
12 authorities under the Dodd-Frank Act, Congress
13 also called for coordination and cooperation among
14 domestic regulators. The Dodd-Frank Act
15 specifically requires that the Commission, the
16 prudential regulators, and the SEC, to the maximum
17 extent practicable, establish and maintain minimum
18 initial and variation margin requirements.

19 At the same time, a CSE's uncleared
20 swaps with a particular counterparty may implicate
21 the supervisory interests of foreign regulators.
22 So, it's important to calibrate the cross-border

1 application of the margin rules to mitigate the
2 potential of a conflict or duplication with other
3 jurisdictions.

4 Therefore, in developing a cross-border
5 framework for margin regulations, any approach
6 that the Commission adopts must take into account
7 Commission supervisory interest in ensuring the
8 safety and soundness of CSEs and the need to
9 harmonize a cross-border application to the extent
10 practicable with the prudential regulators and
11 with foreign regulators.

12 It is essential that the Commission
13 strikes the right balance among these sometimes
14 competing considerations. To that end, Commission
15 staff is closely consulting and coordinating with
16 the prudential regulators, and has participated in
17 numerous bilateral and multilateral discussions
18 with foreign regulatory authorities, including the
19 E.U. and Japan, which have started to develop
20 their own margin rules.

21 Now let me turn to the alternative
22 approaches referenced in the ANPR. Under the

1 first alternative, the Commission's margin rules
2 would be applied on a transaction- level basis
3 consistent with the cross-border guidance. Under
4 this approach, the Commission's margin rule would
5 apply to any uncleared swaps for which a U.S.
6 Person or a U.S. CSE -- except as to its foreign
7 branches -- is a party without substituted
8 compliance available.

9 With respect to a non-U.S. CSE, margin
10 rules would apply to any uncleared swap with a
11 non-U.S. counterparty that is a guaranteed
12 affiliate with substituted compliance available.
13 However, uncleared swaps with a non-U.S.
14 Counterparty that is not a guaranteed affiliate
15 would be excluded from the margin rules.

16 The second alternative discussed in the
17 ANPR is the approach proposed by the prudential
18 regulators in September 2014. The prudential
19 regulators would apply their margin rules to all
20 uncleared swaps of CSEs under their supervision,
21 with substituted compliance available in certain
22 circumstances, and with a limited exclusion --

1 specifically, the prudential regulators would not
2 apply margin rules to certain uncleared swaps
3 between a non-U.S. CSE and a non-U.S.
4 Counterparty where neither counterparty's swap
5 obligations are guaranteed by a U.S. person, and
6 neither party is controlled by a U.S. entity.

7 Under the third alternative discussed in
8 the ANPR, margin rules would be treated as an
9 entity-level requirement. The entity-level
10 approach is similar to the prudential regulators'
11 approach, with one important difference: No
12 exclusion is possible.

13 The staff continues to give a great deal
14 of thought to what model is optimal, and will
15 continue to work closely with the prudential
16 regulators and foreign regulators to harmonize the
17 rules to the greatest extent possible.

18 COMMISSIONER WETJEN: Thank you,
19 Carlene. Sean? Thanks for coming.

20 MR. CAMPBELL: Thanks for having me here
21 today. Just to follow on the remarks of my
22 colleague, Ms. Kim, you know, the part of the

1 Dodd-Frank statute that we're implementing is
2 effectively the same statute. We are covering the
3 swap dealers that are prudentially regulated, so
4 it's essentially the complement of the set that
5 will be covered by the CFTC and the SEC. And so
6 the general sort of nature and tone of the
7 preamble that Ms. Kim provided essentially goes
8 for the rulemaking that we're engaged in
9 promulgating at the Federal Reserve Board, in
10 conjunction with the other prudential regulators.

11 I guess just one thing that I would sort
12 of stress is that the sort of -- the focus on
13 safety and soundness is a key consideration
14 throughout the entire rulemaking, as Ms. Kim
15 alluded to, but it's also very important for
16 thinking about sort of the cross-border
17 application of the rules. Safety and soundness of
18 the swap dealer is a primary consideration that's
19 important for thinking through the mechanics of
20 the ultimate rule.

21 Again, Ms. Kim did a very nice job of
22 summarizing the prudential regulator proposal, so

1 I sort of feel as though my thunder was stolen
2 just a little bit, but just to maybe give a brief
3 refresher course on what she said three seconds
4 ago, if you all need that -- so the easiest way to
5 think about the cross-border application of the
6 rule and the 2014 proposal is, what are the
7 transactions to which the rule would not apply?

8 So, the transactions to which the rule
9 would not apply are transactions that, you know,
10 broadly speaking, one can think of as
11 foreign-foreign transactions. So, the swap dealer
12 in consideration is a foreign-covered swap dealer;
13 that's a swap dealer that is not organized under
14 the laws of the United States of America or any
15 state thereof -- and their counterparty is also
16 not an entity that is organized under the laws of
17 the United States or guaranteed by an entity that
18 is organized under the laws of the United States.

19 So, those are essentially those truly
20 foreign- foreign transactions. Even though they
21 are transactions that are entered into by a
22 covered swap entity under our rule, they are not

1 covered by the U.S. prudential regulator rule.

2 And then the swaps of other covered swap
3 entities would be covered by the rule. And as Ms.
4 Kim alluded to, there would be the possibility of
5 substituted compliance. And so in cases where a
6 foreign rule was deemed to be comparable to the
7 outcomes of the U.S. rule in those circumstances,
8 those foreign swap dealers would be able to use
9 the foreign rule and would not have to use the
10 U.S. Rule in that circumstance.

11 And so, therein, essentially what we're
12 doing in that context is, we are recognizing that,
13 you know, the rules of other jurisdictions -- to
14 the extent that they provide for comparable
15 outcomes -- have a similar effect on the safety
16 and soundness of the swap dealer. And so allowing
17 those entities to use that set of margin rules in
18 their dealings with their counterparties in those
19 jurisdictions will allow for essentially, you
20 know, a good deal of sort of international comity,
21 in terms of competition across global markets, but
22 won't impair the safety and soundness requirements

1 of the rule.

2 So, that's a very brief overview of the
3 cross- border application, but happy to take more
4 detailed questions if people have them.

5 COMMISSIONER WETJEN: Thank you very
6 much, Sean. Well, let's open it up for questions.
7 Does anyone on the GMAC -- any of the GMAC members
8 want to share their views on the relative benefits
9 of any of these three different approaches laid
10 out in our ANPR?

11 I see Angie's raising her name placard.
12 Angie?

13 MS. KARNA: Thank you, Commissioner.
14 When we've looked at the three approaches, two
15 things sort of stand out from some of the comments
16 that have been made at the outset.

17 First of all, the scenario where two
18 truly foreign-foreign are not covered by U.S.
19 Rules is very important to us, and so that is
20 something in common between the prudential
21 regulator approach, as well as the
22 transactional-level approach of the CFTC.

1 But the other thing that's very
2 important -- and Sean alluded to this -- there has
3 been a tremendous amount of international dialogue
4 through BCBS/IOSCO on common standards. And so it
5 seems to us that in a truly global marketplace --
6 which this is -- there should be the maximum
7 opportunity for findings of substituted compliance
8 here than in frankly almost any other set of
9 rules, because there has been so much dialogue.

10 So, from that perspective, the
11 prudential regulators' approach seemed to provide
12 for more substituted compliance, in that if you
13 are a -- there is a possibility of substituted
14 compliance when you're touching the United States
15 of America -- more so than you saw in the
16 transaction-level approach.

17 So, we would encourage you, whatever way
18 the CFTC ends up approaching these rules,
19 foreign-foreign should be out, and maximum
20 opportunities for substituted
21 compliance/equivalence should be explored in the
22 context of rules that have been discussed heavily

1 at an international level.

2 COMMISSIONER WETJEN: Eric?

3 MR. LITVACK: Well, I sympathize with
4 Sean about having his thunder stolen. The prism
5 through which we look at this is what's going to
6 maximize the ability to achieve --

7 COMMISSIONER WETJEN: You kind of have
8 to pretend like you're eating the microphone --

9 MR. LITVACK: Okay.

10 COMMISSIONER WETJEN: -- basically for
11 it to work, I'm afraid. It's a little awkward, I
12 know, but --

13 MR. LITVACK: Right. Gotcha. So, the
14 prism through which we look at this issue is, what
15 is going to maximize the likelihood of achieving a
16 flexible framework for substituted compliance,
17 and, accordingly, preserving global liquidity
18 pools? That's really our big concern. If we
19 don't get an elimination of jurisdictional
20 conflict -- if we don't eliminate competitive
21 disparities, then we are likely to find ourselves
22 splitting the global markets and interregional

1 silos, and that's a bad outcome -- particularly in
2 the context of margin rules, which, as Angie was
3 saying, have been so heavily discussed at the
4 international level.

5 I mean, if we can't achieve recognition
6 deferral/substituted compliance on margins, then
7 we might as well pack up and go home, because we
8 won't get it anywhere else.

9 So, in that light, our concern is that,
10 unlike full substituted compliance, partial
11 substituted compliance under the entity level
12 approach -- or, to a certain degree, under the
13 prudential regulators' approach -- which also can
14 be restrictive -- will not eliminate the
15 jurisdictional conflicts, and will continue to
16 create competitive disparities.

17 We consider that, of the approaches
18 proposed, the transactional-level approach has the
19 most chance of achieving uniformity in margin
20 requirements applicable to all swap participants,
21 whether they're Commission registrants or not
22 serving a particular geographical market, and that

1 it offers relative uniformity and broader scope
2 for substituted compliance.

3 It's also preferable from the standpoint
4 of mitigating compliance costs and reducing
5 opportunities for regulatory arbitrage.

6 And in terms of achieving substituted
7 compliance, our view is that it should apply, as
8 much as possible, to non-U.S. margin rules that
9 conform to the IS and IOSCO framework.

10 While we're on the subject, it would be
11 remiss of me not to mention there's a WGMR
12 implementation program. We are working very
13 heavily on putting together a framework for
14 implementing the margin rules for our members. We
15 have multiple work streams addressing market
16 compliance with rules with regard to initial
17 margin, variation margin, portfolio integrity,
18 risk classification methodology, dispute
19 resolution, margin collateral, data sources, and
20 legal documentation.

21 One of our concerns with regard to that
22 is ensuring that we get global validation of

1 models by regulators as smoothly as possible,
2 because the timelines are incredibly short. With
3 regard to timelines, we appreciate the recent
4 extension to September 2016 of the framework, but
5 we would very much call for a rapid finalization
6 of rules, so that we can actually get into
7 implementation.

8 COMMISSIONER WETJEN: Thank you, Eric.
9 Wally in New York, I see your name placard up.

10 MR. TURBEVILLE: Thanks. It would
11 really be a fine thing if all jurisdictions
12 properly measured the risks associated with
13 derivatives of various kinds, and the risk, once
14 they were collateralized by margin, where
15 everybody was agreeable on that, and that the
16 accounting rules would properly tell us all about
17 the risks associated not doing that. But that's
18 probably not the case.

19 I do think that, leaving that aside,
20 sort of the more than one-world governance side of
21 the discussion aside, I think we have to keep in
22 mind what the point of having these rules at all

1 is. And the point of it is, that the integrity of
2 the U.S. Market, in this case, is -- Congress has
3 determined that it's very important that swap
4 dealers and major swap participants actually act
5 to margin their positions and get margin from
6 their counterparts, and that Congress didn't say
7 people who rise to the level of swap dealers in
8 the U.S. who happen to be from somewhere else get
9 to have a different set of rules.

10 So, I think in this case, that's what we
11 have to focus on. This was designed with not only
12 systemic but also just market process and
13 integrity purposes -- which, by the way, is also
14 different from what the Fed does. The Fed has a
15 different set of mandates, as well -- different
16 from the CFTC.

17 So, I think what ones inevitably gets to
18 is that if we're trying to accomplish this in
19 order to achieve safety, soundness, and proper
20 procedures, and proper functioning in the markets
21 by requiring swap dealers and major swap
22 participants to engage in margining, that, really,

1 that's an entity-level activity. And it doesn't
2 matter if a swap dealer is dealing with a non-U.S.
3 Person; that can impair the integrity of the U.S.
4 Market just as well as if they're dealing with a
5 U.S. person.

6 So, I think we have to just simply keep
7 in mind and be sort of very focused and
8 disciplined about what we're trying to accomplish,
9 which is that, and not necessarily trying to make
10 life easy for various firms that are operating in
11 the market.

12 COMMISSIONER WETJEN: Thank you, Wally.
13 Chris?

14 MR. ALLEN: Thank you. I echo and agree
15 completely with the observations made by Angie. I
16 think that the approach, as promulgated by the
17 Federal Reserve, in terms of its thinking about
18 cross-border, I think, is entirely sound. I think
19 the fact that it looks to exclude truly
20 foreign-foreign transactions from scope, I think,
21 is sensible - although, as has already been
22 alluded to, this is a body of regulation that has

1 attracted a huge amount of international focus
2 and, in many respects, agreement, in terms of
3 application of rules in many different
4 geographies. So, the idea that those activities
5 would not be subjected to some form of an
6 uncleared margin rule, I think, is slim.

7 But I think, also, the approach
8 advocated by the Federal Reserve also increases
9 the instances in which effective substituted
10 compliance is likely to be available -- which, I
11 think, as we've all observed in other contexts, is
12 an important characteristic of trying to make
13 these kind of provisions work in global context.

14 I think, to be fair, of course if the
15 CFTC was to adopt a transaction-level approach to
16 its rule, that would at least be consistent with
17 various other aspects of CFTC rulemaking, which
18 would perhaps be advantageous in certain respects.
19 But I think that that advantage is less persuasive
20 than the merits of adhering to the view that has
21 been put forward by the Federal Reserve.

22 I think just finally, it also is not

1 entirely helpful in circumstances where you have
2 rules which were overseen by more than one
3 regulatory agency for it to be a diverse and
4 fragmented approach in terms of how those
5 different agencies think about the application of
6 those rules on a cross-border basis.

7 So, an alignment of approach on this
8 issue between the CFTC and the Federal Reserve, I
9 think, would be appealing, in terms of reducing
10 that complexity and fragmentation in terms of the
11 application of rules to participants in the U.S.

12 Thanks.

13 COMMISSIONER WETJEN: Adam?

14 MR. COOPER: Thank you. I'm going to
15 agree with Angie and Chris, with a big but and/or
16 footnote. Truly foreign-truly foreign truly
17 should be outside the scope of the U.S.
18 Regulations. But the prudentials' definition of
19 "foreign," I don't think is accurate. It doesn't
20 mirror with the CFTC's definition. It's a very
21 formulistic definition that would say "organized
22 in the U.S.," as opposed to, I think, the proper

1 characterization of U.S. Nexus, which is
2 principal place of business in the U.S.

3 So, non-U.S. fund managed out of the
4 U.S. -- principal place of business in the U.S. --
5 would be considered foreign under the prudentials'
6 definition. And I don't think that is the right
7 construct.

8 As to the entity-level versus
9 transaction-level, I would say transaction-level,
10 we think, makes the most sense. I think the
11 industry -- I think our buy side has invested
12 tremendous resources in building infrastructure
13 for transaction-level compliance, reporting, and
14 all manner of other things; to reorient away from
15 that and to get to an entity-level sort of a
16 construct, I think, would be burdensome, and
17 costly, potentially disruptive.

18 COMMISSIONER WETJEN: George in New
19 York?

20 MR. HARRINGTON: Thank you,
21 Commissioner, and thank you, Mr. Chairman, as
22 well, for holding this important panel.

1 Just a quick note -- I think that many
2 of you will remember on the cleared swap margin,
3 we had a relatively outspoken opinion regarding
4 consideration as far as underlying liquidity. And
5 I think in this instance, that also should be
6 considered whenever looking at what the liquidity
7 characteristics are of the uncleared swaps that
8 are being considered.

9 Certainly, when you look into things
10 like FX NDFs, there are, you know, very, very
11 active pockets of liquidity, and some of the
12 interest rate swap products there also are active
13 pockets of liquidity. And then, of course, as you
14 go out into more esoteric products, you will find,
15 you know, great amounts of illiquidity. That must
16 be considered whenever you're going to be looking
17 at margin.

18 And, also, I think from a U.S. point of
19 view, the fact that you do have options, as far as
20 where these investments will be offered overseas
21 has to be considered, as far as making sure that
22 the margin that's being applied is not too

1 burdensome on the underlying participants, because
2 that certainly could drive that business overseas,
3 offshore, or certainly just put U.S. participants
4 out of that business and not able to participate,
5 which creates a very serious competitive
6 disadvantage.

7 So, I'll once again echo those same
8 concerns that we had on cleared.

9 Thank you.

10 COMMISSIONER WETJEN: Angie. I'm sorry.
11 And then I'll turn to Clive.

12 MS. KARNA: Just for Carlene, who's
13 taking really good notes -- I just want to clarify
14 one thing. I'm not saying that we are in line
15 exclusively with the prudential regulator. What
16 we really liked about the prudential regulator
17 approach was a broader view of substituted
18 compliance, but we actually -- when we looked at
19 the possibilities for conflicts amongst the
20 various rules -- other than that issue, the
21 transaction-level approach to us made the most
22 sense.

1 COMMISSIONER WETJEN: Clive?

2 MR. CHRISTISON: Thanks, Mark. A few
3 points, I think, around this -- and the role that
4 energy plays on a commodity basis.

5 So, I think, firstly, you know, many
6 energy end users obviously aren't swap dealers so
7 they avoid the qualification as a financial end
8 user. Now there are some of us who have swap
9 dealer entities within organizations, which are
10 important in terms of where this is heading.

11 Fundamentally, I think the role of the
12 uncleared swap market is critical for commodities
13 such as oil -- or agricultural metals -- because
14 the importance of quality, time, and location are
15 key factors around how a participant will look at
16 hedging and there are not enough cleared contracts
17 that will be able to cover all those needs,
18 depending on where you're sitting in the world --
19 whether you're a Midwest end user who runs a bus
20 company, looking for a hedge, or the quality of
21 diesel they acquire in that market, versus, let's
22 say, a producer in Brazil, who's producing crude

1 or a virgin quality that's clear today. So, the
2 role of the uncleared swap market is very, very
3 important.

4 I mean, from our perspective, we believe
5 and expect that there should be a set of rules for
6 all market participants that use one set of rules,
7 regardless of where the counterparty is domiciled.
8 And that's truly because the energy market is a
9 global market.

10 When we look at the three approaches, I
11 think the prudential regulatory proposal is one we
12 can probably align more for, for some of the
13 reasons that were already mentioned -- in terms of
14 application is more favorable, it's more
15 consistent -- however, I think you need to be
16 careful about the foreign-to-foreign aspect being
17 left out of that proposal.

18 And if the CFTC was going to consider
19 its rules around the prudential regulatory
20 proposal, I think it needs to look carefully
21 between a financial and nonfinancial participant,
22 and how those needs and applications would apply.

1 From an entity-level approach, again, I
2 think the key thing is around, what constitutes a
3 substituted compliance for both non-U.S. and U.S.
4 Participants? And, that as we all know, that
5 definition is one where a considerable amount of
6 uncertainty remains and needs to be clarified.

7 And finally, I think the transaction
8 approach, while it's very clear if you're sitting
9 here in the U.S., and a participant in the U.S.,
10 for those who are a non-U.S.

11 Domiciled and are truly foreign who
12 don't apply, then I do believe you're risking
13 moving business from the U.S. to other parts of
14 the world, who potentially will play a regulatory
15 arbitrage between what's required here versus
16 maybe required in other jurisdictions -- again,
17 playing back to the global market.

18 COMMISSIONER WETJEN: Tim?

19 CHAIRMAN MASSAD: Thanks Mark. First of
20 all, I just want to note, as Angie and others have
21 said, the importance of trying to get the rules
22 that we will adopt, as well as those that Europe,

1 and Japan, and other jurisdictions will adopt --
2 you know, as much as possible, the same. They
3 won't be the same. But I don't expect they'll be
4 the same -- but certainly on as many issues as
5 possible, we'd like to achieve that.

6 But having said that, I want to pick up
7 on something Wally said. You know, there's
8 probably always going to be jurisdictions that
9 don't have those rules. And I want to ask
10 Carlene, and Sean -- and Paul, also, if you want
11 -- a question that pertains to the phenomenon we
12 saw last year that we looked into, in terms of
13 what was referred to as de-guaranteeing -- a
14 situation where a U.S. parent might have a foreign
15 entity that previously had guaranteed the swap
16 obligations, but then it removed the guaranty.

17 Some participants said that that was in
18 order to avoid being subject to trading rules.
19 Trading rules are one thing. This rule is, to me,
20 fundamental about risk, and fundamental about the
21 risk that transactions can create.

22 And so I guess I'd like to understand --

1 as you think about that issue -- the difference
2 between the guidance approach, transaction
3 approach, if you will, and the prudential
4 regulators' approach. Again, you know, if we have
5 similar rules in other jurisdictions, and we have
6 substituted compliance, that's fine, but if we
7 have a jurisdiction that doesn't have a rule, you
8 know, does something fall through the cracks here?
9 So, maybe Carlene, if I could ask you.

10 MS. KIM: Sure. I mean, the phenomenon
11 that you mentioned -- the de-guaranteeing practice
12 by -- as we understand -- certain non-U.S. swap
13 dealers in order to fall outside Dodd-Frank
14 transaction-level requirement -- is an issue that
15 we're very much concerned about, and we're
16 definitely mindful of it as we are trying to
17 develop a proposal for Commission's consideration.

18 As you may well know, under the guidance
19 approach, transactions between a non-U.S. swap
20 dealer and a non-U.S. Counterparty that is not
21 guaranteed by a U.S. person is entirely excluded
22 from Dodd-Frank transaction-level requirement.

1 And margin requirements, under the guidance
2 approach, is categorized as a transaction-level
3 requirement.

4 Margin rules is interesting, because it
5 is calculated on an individual transaction basis.
6 So, it could be treated as a transaction-level --
7 and for that reason, it was treated as a
8 transaction-level requirement as we drafted the
9 guidance.

10 But in rethinking this issue and looking
11 at the safety and soundness concerns that is
12 intended to be addressed by the margin provision,
13 we think it may be more appropriate to address it
14 as an entity-level. And we, at the staff level,
15 are concerned that, under the transaction- level
16 treatment of margin requirements, that too many
17 uncleared swaps of CFTC-registered swap dealers
18 may be excluded, and, therefore, the risk will
19 come back to the U.S. person and U.S. financial
20 system.

21 For that reason and looking at and
22 considering the prudential approach, where they

1 limit exclusion to truly pure foreign-to-foreign
2 transactions, we think may be worthwhile
3 considering seriously. Under the prudential
4 approach, to the extent that a registered swap
5 dealer has a financial arrangement or financial
6 relationship with a U.S. Person whereby risk to
7 that entity through uncleared swaps translates
8 into risk to the U.S. person, that would not be
9 eligible for any exclusion under the prudential
10 approach.

11 So, taking into consideration the
12 fundamental purpose behind the margin provision,
13 which is to protect the safety and soundness of
14 CSE -- but, of course, keeping in mind, consistent
15 with the long tradition of this agency to take
16 into consideration seriously the supervisory
17 interests of foreign regulators. In appropriate
18 circumstances, we are balancing, and weighing the
19 different issues, and trying to develop an
20 approach that, first of all, addresses the
21 purposes of the margin provision.

22 MR. CAMPBELL: So, I don't have too much

1 to add relative to Ms. Kim's remarks in that area.
2 I would just say, you know, one further point that
3 I would make that was already stressed by somebody
4 else in the panel is that the international work
5 that's been going on in this area, I think, is
6 extremely important, because, as was already
7 mentioned by somebody else on the panel here
8 today, there's a relatively broad agreement
9 amongst a very large number of jurisdictions about
10 how the global framework for margin requirements
11 ought to be structured across the globe.

12 And, of course, I would readily admit
13 that the set of jurisdictions that have signed up
14 for that framework is not the entire world; that
15 is surely the case. But if we think about, in
16 particular, the cross-border approach that's taken
17 in the prudential regulator rule set, and you sort
18 of ask yourself, you know, what
19 provisionally-registered swap dealers potentially
20 are going to sort of escape any sort of
21 regulation? I think there, I would challenge
22 somebody to find me a swap dealer on that list

1 that wouldn't be subject to regulation in some
2 jurisdiction that has signed onto the BCBS/IOSCO
3 framework.

4 And so I wouldn't reject out of hand the
5 possibility that the circumstance that's being
6 described could occur, but I think that, generally
7 speaking -- at least in light of sort of the
8 current arrangement of the global financial system
9 as we have it today, and where they tend to be
10 located across the globe -- that we've got a very
11 large swath of the financial system covered.

12 And it may not be the specifically --
13 you know, under the prudential regulator proposal,
14 it may not be the "U.S. Rule" which is going to
15 apply to some set of transactions, but, for sure,
16 there will be a rule that will apply, which is
17 probably consistent with an internationally
18 agreed-upon framework. And I think, at least
19 within the context of the prudential regulators,
20 that specific fact pattern is a sort of primary
21 rationale in sort of a pillar of the underlying
22 motivation for the approach that we took in the

1 proposal.

2 COMMISSIONER WETJEN: Darcy, in New
3 York?

4 MS. BRADBURY: Yeah, I just wanted to
5 make a brief comment about unintended consequences
6 -- and even using the example of the un-guaranty
7 or the de-guaranteeing -- you know, one of our
8 biggest concerns -- because an investment firm
9 based in New York, although we have some offshore
10 funds and some domestic, we're a U.S. person. And
11 I think we would not want to have diminished
12 competition for our business if banks and other
13 dealers truly feel that the U.S. System is not
14 one that they want to engage in. If we begin to,
15 you know, have fewer firms that we can do business
16 with, we won't be able to do as good a job for our
17 investors.

18 So, just sort of thinking about that --
19 so all of this substituted compliance and those
20 kinds of things would be very important if we're
21 going to maintain access to a broad set of dealer
22 counterparties -- and, also, to be able to

1 distribute our counterparty risks, since, in this
2 case, these are uncleared trades -- so just ask
3 you to keep that in mind.

4 COMMISSIONER WETJEN: Thank you. Let's
5 tee up another topic here in the context of the
6 margin rule -- and that's the proper treatment of
7 these inter-affiliate trades, which tend to be
8 international in nature, given the way that global
9 firms manage their risk.

10 The CFTC proposal proposed imposing both
11 initial and variation margin on those
12 inter-affiliate transactions. So, wanted to see
13 what the members of the Committee here had to say
14 about that.

15 We, of course, looked at this a little
16 bit differently in the case of cleared swaps. We
17 have an exception from the clearing requirement
18 for inter-affiliate trades -- some inter-affiliate
19 trades, based on whether or not certain conditions
20 could be met. And so this is a slightly different
21 take on it reflected in the proposal from last
22 fall.

1 I see Jim has his placard up. Jim, do
2 you have any views on this?

3 MR. HILL: So, we've dealt with some
4 very challenging issues today. I'd like to think
5 this maybe is one of the easier ones that I think
6 does have a right answer.

7 And that is -- let me just spend a
8 minute to talk about why a bank would do these
9 inter-affiliate trades first, because I think it
10 really sets the table well for what we think the
11 right answer is.

12 A bank probably has a
13 European-registered entity, which transacts with
14 European clients. And that bank might also have a
15 U.S.-registered entity, which transacts with U.S.
16 Clients.

17 And typically, the European clients are
18 trading European-based product, and that
19 transaction would be booked -- the client
20 transaction would be booked in the European
21 entity, and the European entity would hedge that
22 exposure on the European markets, either with

1 another European client or in the European
2 interdealer market.

3 And when U.S. clients are transacting in
4 U.S.- based product, the transaction is both in
5 the U.S. entity and then hedged in the U.S.
6 Markets with either U.S. clients or in the
7 interdealer market.

8 From time to time -- and it happens
9 often -- a European client will want to transact
10 in a product that is generally traded out of the
11 United States. So, that client -- its primary
12 counterparty is a European entity. It transacts
13 with that European entity. The transaction now
14 needs to be hedged, and so because the transaction
15 typically trades in the U.S. markets, the U.S.
16 Entity will hedge in the U.S. markets.

17 Now as a firm, we are flat-risk. But
18 each of those entities -- one is long, and one is
19 short. And so an inter-affiliate trade is done to
20 move the risk -- in this case, from Europe to the
21 U.S., such that the European entity is flat, and
22 the U.S. entity is flat, as well. And the risk is

1 managed out of the United States.

2 The same would happen if a U.S. client
3 transacted in a European product; the risk would
4 be moved back to Europe.

5 So, what those transactions do is
6 actually flatten out the risk among the regulated
7 entities. If those transactions were either too
8 expensive or not permitted, the inter-affiliate
9 transactions, what would happen is, the hedging
10 would happen exactly as I described. So, as a
11 firm, the bank would be flat-risk, but each of the
12 two entities would actually be off-sides. One
13 would be long, and one would be short.

14 It is, I think, for that reason, the
15 CFTC exempted those trades from the clearing
16 mandate. The CFTC made a decision that those
17 transactions have an important risk management are
18 an important risk management tool, and imposing
19 clearing on them would raise the costs. People
20 probably wouldn't do them. You'd end up with more
21 risky entities, and, therefore, the exemption from
22 clearing was granted, subject to certain

1 requirements.

2 We think the exact same logic applies
3 with respect to the margin requirement. In fact,
4 if you impose the margin requirement on those
5 transactions, you're effectively eviscerating the
6 exemption that you gave for clearing, and making
7 it more expensive than clearing.

8 And so for the CFTC to be consistent in
9 its rulemaking -- and, also, for us to be able to
10 manage our risk effectively -- we think it's very
11 important that the exemption apply for margin, as
12 well. And remember, we're only talking about
13 initial margin here. So, those transactions will
14 be fully margined on a mark-to-market basis, with
15 a variation margin. It's just the initial margin
16 that we're talking about.

17 COMMISSIONER WETJEN: It looks like
18 Angie had her placard up next.

19 MS. KARNA: Well, I'll be brief, because
20 I was going to say most of what Jim said. But I
21 will just add a couple of additional comments on
22 top of everything he said, which I agree with.

1 First of all, when we think about
2 inter-affiliate margin, we also agree entirely
3 that you already have a solution. The CFTC was
4 very thoughtful when they thought about clearing,
5 and we think this is the other side of that.

6 When we think about the reasons why we
7 would want to have inter-affiliate margin not
8 disincentivized, it's really from a risk
9 management point of view. We think it creates
10 risk management problems to have basically
11 isolated, and ring-fenced, and balkanized regions
12 of risk where Europe and the United States are
13 separated.

14 And the other thing that I would
15 highlight -- which I don't think -- Commissioner,
16 you may have mentioned in your introductory
17 comments -- when we look at rules around the
18 globe, right now, we don't see inter-affiliate
19 margin from an IM perspective being applied in
20 Japan, nor do we see it in Europe. So, we see
21 that there's a real disconnect between the U.S.
22 And Europe and Japan, and that causes us more

1 concern from people sitting in the United States.

2 And then going back to one of Darcy's
3 comments earlier -- we're very concerned about
4 making sure that U.S. Clients have access to the
5 greatest amount of liquidity, and we think that if
6 we're adding inter-affiliate margin costs in the
7 United States and not elsewhere, we're going to
8 see a decrease of liquidity in this market.

9 COMMISSIONER WETJEN: Jim?

10 MR. HILL: Just to follow up with one
11 other point on this -- my understanding from sort
12 of wandering the halls of this building is, one of
13 the reasons why the CFTC is considering not
14 providing an exemption is that the prudential
15 regulators took a different approach.

16 And I think it's worthy of note that the
17 prudential regulators have taken the approach
18 they've taken because of other banking
19 regulations. So, there are regulations which
20 require banks to treat their affiliates the same
21 way they treat third parties.

22 And as a result, the prudential

1 regulators felt the need to impose upfront margin
2 on affiliate transactions, because they're
3 required on third-party transactions.

4 That obviously is not applicable to the
5 CFTC, and I think that that's an important
6 distinction that you should be mindful of when
7 thinking about this issue.

8 COMMISSIONER WETJEN: Chairman?

9 CHAIRMAN MASSAD: So, let me make sure I
10 understand, then. You'd rather we be inconsistent
11 with the prudential regulators. On the other
12 step, you were all saying you've got to be
13 consistent.

14 MR. HILL: Yes, but the reason is, there
15 was a rule --

16 CHAIRMAN MASSAD: Okay.

17 MR. HILL: No, but this is important.
18 The rule that the prudential regulators have
19 promulgated in this context is a function of a
20 banking rule that doesn't necessarily apply in the
21 context of the CFTC requirements, and we think in
22 this case, it results in a rule that doesn't

1 actually make a lot of sense, from a risk
2 management perspective, and it also doesn't make
3 sense in the context of previous exemptions you've
4 given --

5 CHAIRMAN MASSAD: And what will this
6 difference in our rule -- if we were to end up
7 different from theirs, what incentives will that
8 create? How will people then organize their
9 businesses? Play that through for me.

10 MR. HILL: I can't answer for the other
11 firms; it won't change our behavior -- I don't
12 believe, anyway.

13 But I think it's important to note that
14 in the context of the clearing exemption, the
15 reason why you were able to act the way you did in
16 providing that exemption is because the prudential
17 regulators don't have clearing rules, right?

18 So, you do, and you've made a decision
19 around clearing, and it's important to be
20 consistent with respect to margin, because if you
21 don't, if you aren't consistent, you're
22 effectively eliminating the clearing exemption

1 that you've already given. Well, let me explain
2 why -- because if the trade doesn't have to be
3 cleared, but, instead, we have to post upfront
4 margin, the amount of upfront margin that we have
5 to post is actually substantially higher than the
6 amount of margin we would've had to post had we
7 cleared the trade.

8 So, effectively, the clearing exemption
9 means nothing.

10 COMMISSIONER WETJEN: Since we have a
11 representative of one of the prudential
12 regulators, Sean -- and not that I don't believe
13 Jim about the rationale behind imposing IM in the
14 Fed's proposal -- but is that the reason, or might
15 there be other reasons, too? What's your view?

16 MR. CAMPBELL: Sure. So, again, I can't
17 speak for the Board, and I certainly can't speak
18 for the other prudential regulators, but certainly
19 I think, thinking about the proposal, and the
20 preamble, and the discussion of this issue of
21 inter-affiliate transactions, I think the point
22 that Jim made is in part correct; that there are

1 other banking regulations which do place
2 limitations and restrictions on the dealings
3 between banks and their affiliates -- so-called 23
4 A&B rules, and Reg W, and so forth -- so that is a
5 relevant consideration.

6 But I think that there are other
7 considerations at play, as well, which is -- I
8 think the fact pattern that has been articulated
9 certainly occurs -- and, you know, that is one
10 situation or one fact pattern under which inter-
11 affiliate swaps may occur, but it need not be the
12 only fact pattern.

13 So, you can imagine a large bank holding
14 company -- the types of which are regulated by the
15 Federal Reserve that, say, has an insurance
16 company under the holding company structure.

17 And in a situation like that, you could
18 imagine a situation where an insurance company
19 that engages in swaps -- as many insurance
20 companies engage in lots of swaps -- they'll now
21 have a choice. They can either do a trade with a
22 swap dealer under the holding company, or they can

1 do a trade with a swap dealer outside the holding
2 company.

3 And in a situation where there's no
4 inter- affiliate margin, to Chairman Massad's
5 point, you might imagine it's not a very
6 complicated calculation to figure out which dealer
7 they're going to be doing their business with.

8 And so to the extent that those trades
9 actually do present and create some degree of
10 counterparty risk when the insurance enters into a
11 swap -- I think recent history shows that that
12 does create a certain degree of counterparty risk
13 for somebody -- that those trades ought to be
14 margined.

15 COMMISSIONER WETJEN: Jim?

16 MR. HILL: If I can respond to that --
17 if you look at the exemption that you provided for
18 clearing, there are certain requirements that you
19 have to satisfy -- one of which, I believe, is
20 that you are regulated as a swap dealer -- or
21 similar regulations in a foreign jurisdiction.

22 So, I think that, in the example you're

1 giving with the insurance company, the exemption
2 would not be available.

3 COMMISSIONER WETJEN: Or, in this
4 context, perhaps there's a way to address that
5 problem without requiring IM across the board
6 (inaudible).

7 MR. HILL: Yeah, we certainly would
8 support a requirement that both entities -- the
9 affiliates that are transacting -- need to be
10 registered as swap dealers or be subject to
11 similar regulation in the local jurisdiction. And
12 I'm pretty sure that's a requirement of the
13 clearing exemption.

14 COMMISSIONER WETJEN: Let's go to our
15 friends in New York. Doug?

16 MR. HILL: Thanks. One of the reasons
17 for the Commission's increased scope and expanded
18 mandate for the last six years is because of the
19 success of the futures model during the financial
20 crisis and before. Margining worked for futures.
21 Margining continues to work for futures.
22 Margining should work for other transactions.

1 That said, the unmediated application of
2 the proposed rules to the inter-affiliate
3 transactions yields some side effects that are
4 problematic -- particularly around double-counting
5 -- concern that the inter-affiliate transactions
6 -- if they're applied to the \$3-billion dollar
7 material swap threshold -- that's the
8 double-counting. If they're applied to the
9 \$65-million dollar margin requirement threshold,
10 that's a double-counting.

11 And in addition, the reduced level at
12 which affiliate-dom is measured -- 25 percent
13 rather than 50 percent -- actually exacerbates
14 those double-counting issues, and you end up with
15 a situation where what I think was meant to be
16 somewhat of a relaxation becomes more restrictive
17 -- maybe even punitive. But I think the issue is
18 really in the details, not in the general idea.

19 Thank you.

20 COMMISSIONER WETJEN: Thank you, Doug.

21 Supurna?

22 MS. VEDBRAT: I'm just going to, you

1 know, add to some of the comments that Jim, Angie,
2 Darcy had made.

3 You know, one, there is a difference
4 between the cleared swap and the uncleared swap.
5 We're actually taking the counterparty risk off
6 the entity that we're facing. So, from a buy-side
7 perspective, if we just use Jim's example, you're
8 either going to end up with your pricing
9 increasing -- because the double margining and
10 what have you -- that's going to essentially get
11 passed onto the end user -- or it's going to be,
12 you know, a very onerous and long exercise, where
13 you are essentially going to have to repaper your
14 counterparty documents, your ISDA documents with
15 not only the European entities in that example, as
16 well as the U.S., if you want to be able to get,
17 you know, true exposure to the markets that you're
18 looking for.

19 So, you know, as we're making all these
20 decisions, if that could just be, you know, a
21 valid consideration -- it's not really an easy
22 exercise to do the repapering. And I think having

1 increased pricing, you know, for the end user,
2 where you essentially have flat risk, should be
3 something that the Commission should keep in mind.

4 COMMISSIONER WETJEN: Wally, and then
5 we'll turn to Eric.

6 MR. TURBEVILLE: Okay, just quickly -- I
7 think it would be a good thing if the Commission
8 and maybe the staff would look at the resolution
9 authority proceedings that have gone on in rule
10 makings, because just to -- I suspect there might
11 be some implication for that, since, in resolution
12 authority, the primary strategy is to pull out
13 subsidiaries of a systemically important bank, and
14 separate them out so that each -- it might be a
15 good thing if subsidiaries, even though they're
16 inter-affiliates, were independently margined.

17 The second thing, just as an observation
18 -- it is true that this makes the uncleared
19 alternative more expensive than clearing, but the
20 uncleared alternative wasn't intended as a
21 business opportunity; it was intended as a policy
22 which was to be actually discouraged. The thought

1 was that it would be more expensive, and that's
2 okay.

3 COMMISSIONER WETJEN: I think I'll try
4 and stay in order. Caitlin, you actually had your
5 name placard up, as well. And then we'll turn to
6 Eric, and then Jim, and then Angie.

7 MS. KLINE: Yeah, I just wanted to make
8 a quick point. I do take issue with this idea
9 that with inter- affiliate trades, you know, you
10 have your trade conducted in London with a
11 European counterparty that needs to hedge in New
12 York, and that because of the margin -- or for
13 really any reason -- that they would go un-hedged,
14 right? I mean, that I don't think actually
15 happens in practice. Certainly, I never saw it
16 happen in practice -- and, also, is a pretty
17 irresponsible way to approach your business line
18 -- to say, oh, because there is -- you know, what
19 I think everyone agrees is sort of the baseline
20 risk management for derivatives -- which is, like,
21 you know, basic initial margining -- because I
22 have to do that with my own inter- affiliate swap,

1 I will otherwise not hedge my derivatives risk --
2 is, I don't think, a reasonable alternative
3 scenario. I don't think that is what happens in
4 practice, and I don't think it's what's being
5 encouraged by this.

6 I think, also, the alternative is, if
7 you're not going to hedge internally with your
8 affiliate trader in New York, you're going to
9 hedge with somebody, and you're going to end up
10 paying that with somebody, right? So, I'm not
11 sure where this enormous advantage comes to from
12 staying -- other than that you have netting
13 benefits from not having to clear. You already
14 have this sort of exemption existing.

15 So, I don't -- it's not clear to me
16 that, for some reason, inter-affiliate trades have
17 some sort of special status, and they need to not
18 -- they're going to become so expensive that,
19 through margin, we need to give them this clear.
20 And that's not a good practice or a reason not to
21 hedge, because it's too expensive. Hedging is
22 hedging.

1 COMMISSIONER WETJEN: Eric, and then
2 Angie.

3 MR. LITVACK: So, there's a few points
4 that have been raised that I'd like to address
5 quickly. One was this issue of whether we should
6 be accounting for resolution rules. And I think
7 we need to be clear what we're aiming at in
8 margins for uncleared. We're not trying to solve
9 for the problem of resolution or individual firms
10 failing; we're trying to solve for the problem of
11 contagion.

12 So, as Jim says, if you have got
13 (inaudible) that is margins, and that is solving
14 for the contagion problem.

15 I also want to take issue with this
16 notion that we're somehow trying to discourage
17 uncleared. The notion of cleared (inaudible) --
18 a transaction that should be cleared is generally
19 mandated to be cleared and will be cleared anyway.
20 And in any event, a cleared transaction, at least
21 for a dealer, will always be cheaper than a
22 uncleared transaction.

1 But we shouldn't engage in an attempt to
2 discourage uncleared transactions, because there
3 will be lots of products that will not inherently
4 clear that probably we don't want to push into
5 clearinghouses, because they may not have the
6 liquidity or the market size to have a viable
7 economic model for clearings. So, I don't think
8 we should be pushing products that are valuable
9 hedging tools that are currently uncleared, either
10 outside of the market or through a clearinghouse
11 when it's not appropriate.

12 As to the cost of the margins, Supurna
13 raised the issue of how costs would be passed onto
14 the end user, and I thought it'd be useful to put
15 some numbers around that double-margin effect.

16 We ran some simulations, and the likely
17 cost of having to double-margin between
18 transactions would be effective, down to 100
19 percent more margin -- which is a sizable amount
20 that inevitably would be passed onto the end user
21 -- or simply discourage use, discourage hedging.

22 And finally, a point that probably is

1 worth mentioning is that if you are imposing this
2 requirement to hedge between affiliates -- and,
3 again, it needs to be a targeted exemption --
4 you're actually creating increased risk facing the
5 margin custodian. So, I'm not sure that you're
6 actually ending up any better off net-net.

7 COMMISSIONER WETJEN: Angie, and then
8 Jim.

9 MS. KARNA: So, just to touch on a
10 couple of points -- Eric already covered some of
11 them -- one of them is, I don't think that --
12 speaking on behalf of Jim -- I don't think the
13 example that Jim was mentioning was a reference to
14 having unhedged exposure. What that was, really,
15 is talking about that we would have more isolated
16 risks that are hedged more to the Street, as
17 opposed to between affiliates, and that causes
18 more risk accumulation, less efficiently, in two
19 different parts of the world.

20 But the other thing I wanted to just
21 mention, Commissioner, is, I want to just level
22 set, so we're not talking about, you know, apples

1 and oranges. I think when we're talking about --
2 at least what we're talking about at my firm -- as
3 a sensible approach and following your clearing
4 exemption is not a carte blanche.

5 We're talking about having variation
6 margin applied. We're talking about having
7 capital charges for credit risk applied. We're
8 talking about only covering swaps that are subject
9 to a group-wide consolidated risk management
10 program. We're only talking about swaps that are
11 fully documented with swap-trading relationship
12 documentation.

13 Both counterparties would have to be
14 subject to consolidated financials. A non-U.S.
15 Affiliate counterparty would have to be in a
16 region where it is, itself, subject to margin
17 requirements that are BCBS/IOSCO equivalent.

18 And then finally, overall, we're not
19 talking about taking things and moving them to
20 another part of the world in a large amount to
21 evade any kind of rules. We're talking about
22 rules -- going back to the beginning of this

1 discussion -- that have already been subject to
2 significant international discussion and attempts
3 to conform them.

4 COMMISSIONER WETJEN: Jim, you get the
5 last word.

6 MR. HILL: Excellent. So, I think Angie
7 really hit the nail on the head, but just to
8 explain this again, so there's no confusion --
9 we're not suggesting that trades would go
10 unhedged. What we are saying is that one trade
11 would be done in Europe, the hedge would be done
12 in the United States in two different entities --
13 so the firm has hedged their risk. It's simply a
14 matter of moving the risk to where the risk
15 management occurs, which is, in my example, in the
16 United States, via back-to-back, which is fully
17 margined on a mark-to-market basis.

18 And to address the point about the
19 clearing exemption -- I think it was suggested
20 that although there is this clearing exemption,
21 the Commission really didn't want us to use it or
22 something. I'm going to read from the preamble to

1 the clearing exemption. So, we'll actually close
2 this with your words, not mine.

3 But in talking about the clearing
4 exemption for inter-affiliate trades, the
5 Commission said, "In considering the risks and
6 benefits, the Commission was guided in part by
7 comments pointing to the risk-mitigating
8 characteristic of inter-affiliate swaps and the
9 sound risk management practices of corporate
10 groups that rely on inter-affiliate swaps."

11 And it was on that basis that the
12 Commission granted the exemption to clearing, so
13 that we would continue to do those inter-affiliate
14 swaps -- the exact same rationale applies for
15 uncleared swaps.

16 COMMISSIONER WETJEN: Thanks. I
17 actually have one follow-up question, directed to
18 Sean. Sean, to what degree are folks at the Fed
19 thinking through this argument that if
20 inter-affiliate trades -- at least within
21 companies part of the same holding company --
22 become too expensive that they're no longer done,

1 to what degree is that going to increase the
2 complexity of the firm as a whole? How does that
3 affect regulators as supervisors? And, God
4 forbid, how does that impact or make more
5 difficult resolving a firm?

6 MR. CAMPBELL: Sure. So, I can't say
7 too much about sort of the specific internal
8 machinations of the Federal Reserve, given that
9 we're in an act of rulemaking. But I would say,
10 when we look at the comments that we received on
11 the September proposal --

12 COMMISSIONER WETJEN: Sean, could you
13 move to the mic just a bit?

14 MR. CAMPBELL: Oh, sorry. So, when we
15 look at the comments that were received on the
16 September proposal, you know, the rules around
17 inter-affiliate margining -- if that wasn't the
18 number-one vote-getter in terms of comments
19 received, it's on the, you know, Dave Letterman
20 top 10 list. So, we received a wide array of
21 comments raising several of the points that have
22 been raised here this afternoon -- issues relating

1 to resolution, issues relating to risk management,
2 issues relating to complexity, and I think that,
3 you know, we're currently in the process of trying
4 to sort through all those comments and think
5 through those issues.

6 And I think it's fair to say that the
7 inter- affiliate margining issue -- I think
8 somebody said at the beginning -- and I'm
9 paraphrasing -- and maybe not so well -- that, you
10 know, we discussed a lot of difficult things here
11 today; this is a relatively easy one.

12 Speaking for myself, I think there's a
13 lot of subtle issues that arise in the context of
14 these inter- affiliate margin trades that the
15 agencies are working through, as we work towards a
16 final rule.

17 COMMISSIONER WETJEN: Mr. Chairman,
18 Commissioner Bowen, Commissioner Giancarlo, any
19 last words from you?

20 COMMISSIONER GIANCARLO: Yeah, thank
21 you, Mark. There's been some very good commentary
22 here in New York, but nothing for me to say, other

1 than thank you very much for a great meeting
2 today.

3 CHAIRMAN MASSAD: Same here -- thank
4 you.

5 COMMISSIONER BOWEN: Yep, thank you.

6 COMMISSIONER WETJEN: Okay. With that,
7 I'll turn it over to Dani.

8 MS. BARRETT: At this point, as the GMAC
9 DFO and Temporary Chair of this Committee, I am
10 adjourning this GMAC meeting. Thank you.

11 COMMISSIONER WETJEN: Thanks very much.

12 (Whereupon, the PROCEEDINGS were
13 adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

DISTRICT OF COLUMBIA

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

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