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COMMODITY FUTURES TRADING COMMISSION

CFTC-SEC STAFF ROUNDTABLE

ON CLEARING OF CREDIT DEFAULT SWAPS

Washington, D.C.

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- STEVEN GRESKA
- SARAH JOSEPHSON

SEC:
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- JEFF MOONEY
- PETER CURLEY

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  J.P. Morgan
- MICHAEL BODSON
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- JAMIE CAWLEY
  Javelin Capital Markets
- ATHANASSIOS DIPLAS
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- CHRISTOPHER EDMONDS
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MR. RADHAKRISHNAN: Good morning. My name is Ananda Radhakrishnan. I'm with the CFTC, and welcome to the joint SEC-CFTC staff roundtable discussion on credit default swaps. We have a distinguished panel of participants today and I appreciate their willingness to come here and answer questions from staff. The roundtable will take from 9 o'clock to 12 o'clock. There is another roundtable which starts on 1 o'clock on a different subject.

The objective of this roundtable is to get what I would consider to be a fulsome discussion on credit default swaps, the risk management aspects of credit default swaps, specifically the most appropriate way of margining credit default swaps when they are cleared by a clearing organization. And as you know, the Dodd-Frank Act divided the world of credit default swaps between the CFTC and the SEC. The CFTC has those instruments for which the underlying is a
broad base index and the SEC has jurisdiction over those instruments for which the underlying is a narrow base index and single credit default swaps. So I hope that in the discussion we will get recommendations on how credit default swaps should be margined in the clearinghouse. And then secondarily with respect to those instruments that are not margined -- I beg your pardon -- that are not cleared, how the CFTC and SEC should go about setting margin requirements on dealers and major swap participants, both on the security side and the CFTC side. And what sort of considerations we should take into account with respect to setting capital requirements on dealers and MSPs on our side and the SEC side.

And then finally, I hope that we can have a discussion on whether there should be any special considerations for the business conduct standards that we've been charged with writing for swaps dealers and MSPs both on the CFTC side and the SEC side.

With that I'm going to turn over to John
Ramsay, my colleague from the SEC, for his opening remarks. Thank you.

MR. RAMSAY: Thanks, Ananda. And I don't have too much to add. Before I forget to do it though I should mention that if I accidentally express any views, they are my own and not those of the Commission or any of my colleagues on the staff. And I just want to say that we're very grateful to all of our distinguished guests who have chosen to give their time to come here to discuss some very complicated issues, things that we at the SEC and our colleagues of the CFTC are being asked to address in quite a short time period. This is just one in a series of events, roundtables, ongoing discussions happening all the time between the staff of our two agencies and we're very -- we're grateful for the very productive, helpful dialogue that we've had. And I'm using that expression that misery loves company and we need all the company we can get.

So, anyway, I will I guess start it off there. Do you want to do introductions, Ananda?
MR. RADHAKRISHNAN: Sure.

MR. RAMSAY: All right. Go ahead.

MR. RADHAKRISHNAN: So let me just have CFTC staff introduce themselves. We have two at the table. One is not here right now but Steve.

MR. GRESKA: Steve Greska, and I'm with the risk surveillance section in Chicago in our Chicago office. And joining us later will be Sarah Josephson, who will -- heads up our new OTC division within DCIO.

MR. RADHAKRISHNAN: And then just to make one point, I'll echo what John said, any -- if we offer any opinions it's that of the staff and it should not be construed as that of the Commission as a whole or of any individual commissioner.

A couple of housekeeping -- if you would like to talk you've got to press this button here so the red light comes on and then make your remarks. So, and this is Sarah Josephson, also with DCIO. So I'm going to turn it over to my SEC colleagues. Thank you.
MR. RAMSAY: I have here with SEC staff Jeff Mooney, assistant director, division of trading and markets. Peter Curley is an attorney fellow also in our division of trading and markets.

MR. RADHAKRISHNAN: So maybe we could have the participants introduce themselves and then we can start with the questioning. Thank you.

MR. DIPLAS: Yes, hi. I'm Athanassios Diplas from Deutsche Bank. I'm also representing ISDA as a co-chair of the Credit Steering Committee.

MS. TAYLOR: Kim Taylor, CME Clearing.

MR. EDMONDS: Chris Edmonds, president of ICE Trust.

MR. IVANOV: Stan Ivanov, chief risk office for ICE Trust.

MR. GRAULICH: Matthias Graulich, Eurex.

MR. BODSON: Mike Bodson, COO, DTCC.

MS. JOHNSON: Kristin Johnson, Seton Hall Law School.
MR. PIRRONG: Craig Pirrong, University of Houston.

MR. TURBEVILLE: Wally Turbeville, Better Markets, a non-profit organization.

MR. GOOCH: Jeff Gooch, CO of MarkitSERV.

MR. CAWLEY: Jamie Cawley from Javelin Capital Markets, also representing the Swaps Derivatives Market Association.

MS. MARTIN: Lynn Martin, chief operating officer, NYSE Liffe US.

MR. RADHAKRISHNAN: Thank you. And since our colleagues from the SEC traveled all the way from the SEC I'm going to let them start off with the questioning.

MR. RAMSAY: Thanks so much. I thought perhaps we might start off with a little bit of a recap of the evolution of the CDS market in recent years which has been a lot about the increasing standardization of those products. ISDA has been heavily involved in that effort and Athanassios has agreed to give us a short history lesson and
remind us how we got to where we are today and
maybe say a little bit more to about current
efforts to further the process of standardizing
these instruments.

MR. DIPLAS: Great. Thanks a lot, John.

As you just said, the effort on standardization
started a few years ago. I would say probably
since 2006 we have started looking at ways to
improve the instruments and make them more
suitable for clearing eventually. The effort
obviously intensified when we started dealing with
credit events. We had to come up with a credit
event auction process that started back in
2006-2007 and has evolved since then. Obviously,
the auction portion was fundamental in order to
ensure that transactions can be settled centrally
and not kind of bilaterally as used to be the case
before. In order also to move towards a clearer
state we also had to ensure that any decisions
market-wide actually get done at the central level
and not bilaterally. And the CCP has always to be
sure that it is going to be a flat risk at the end
So that led to the — to an effort that we -- and the protocol that we call the big bang, which basically tried to create a determination committee and also introduce other aspects of standardization. And that was followed by the small bang that actually took those changes and expanded them also to include other credit events such as restructuring.

One of the most, very important also changes in the conduct was the introduction, especially for the North American conducts but also for Europe with what we call SNAC, the Standard North American Conduct which actually standardized the coupons and we had already standardized maturities and that basically made the conduct a little bit more widget-like and that was obviously easier from a risk management perspective for the CCP to manage these conducts in the event of default.

Again, a lot of the effort, if you look at the standardization, people a lot of times have
looked at the standardization of economic terms, such as coupons. The reality is that the most important standardization, the thing that we have achieved and we'll actually keep striving to achieve with respect to legal standardization and process standardization. And that's why, for example, the big bang was extremely instrumental. The determination committee is fundamental. Without the ability to make those decisions centrally and have them be binding for all participants, the framework, if we tried to put it in place right now, would not have worked.

So this is obviously -- has already taken place. And as we progress, right now we will keep looking at new areas, to mention actually more complicated to kind of move the same way. So in that respect clearly there's not actually much more to be done in that respect for indices or single names but then we're looking to do more work in (inaudible), et cetera. But if you look right now at credit CDS and compare it to other asset classes, I would say that actually we
have achieved probably the highest degree of
standardization in the asset class.

At the same time the asset class itself
was more conducive to standardization as opposed
to other asset classes such as interstate swaps
because the needs of the participants were
different and actually were able to tolerate more
standardization. If you look at interstate swaps,
for example because of hedge accounting, etcetera,
they have to -- they require a specific date if
they have a bond they need to hedge. These needs
are not the same on the credit side and that's why
we're able actually to achieve as much as we have
achieved.

MR. RADHAKRISHNAN: Thanks. Sorry,

before I go further, a couple of other technology
points. It may be obvious to you but this meeting
is being recorded so you should know that. And
also, please refrain from putting any BlackBerrys
or cell phones on the table as they are known to
cause audio interference.

I'd like to talk about clearing. And
I'm going to ask this question first of the clearinghouses that are here but then, you know, others can please chime in. What product characteristics are prerequisites for the clearing of credit default swaps? And in particular, please discuss the degree of standardization that is essential -- that you believe is essential for clearing, the availability of reliable price information, and what elements of liquidity -- market liquidity -- do you look for before you decide to clear products. So maybe we can start with Kim. Thank you.

MS. TAYLOR: Thanks, Ananda. The types of characteristics that we look for in being able to clear a product include the standardization of the terms, and by that we mean that there is complete clarity among market participants of what is being traded. So the standardization of the contracts is important. I think the availability of pricing information sufficient to allow us to provide a good representation of market price on any given day for the market to market process and
also the ability to model the risk characteristics of the character on a looking forward basis so that we can appropriately assess the risk and appropriately calculate the margin requirement. Those are very important characteristics.

As far as the liquidity in the market, we do look at the availability of transparent pricing in the market. We do look at the market composition. So a market with a broader set of participants is preferable to a market with a smaller set of participants. Although please keep in mind that with setting up a risk management regime there are ways to compensate for certain deficiencies up to a certain extent. So if there's a less liquid marketplace you can compensate for that to some extent with a higher margin or with a different type of guaranty fund or a different type of default management process. So also we're looking for products that we would be able to have comfort that we would be able to access the marketplace in a crisis situation should we need to liquidate the portfolio.
MR. EDMONDS: I don't know that it would be much different than what Kim went through at a macro level. Everything we've done so far has been on a risk base model. And I'm going to turn it over to Stan and let him walk through more of the specific characteristics of both the sectors as well as the index.

MR. IVANOV: In general, we developed a very specific rules and practices for selection of single names and indices that would be cleared. We looked specifically at the open interest in terms of recorded transactions at the trade warehouse. We also look at the number of counterparties that would participate. We have a minimum number of counterparties that would be involved in keeping positions in those instruments that we would be interested in clearing. There is a minimum number of such participants. We have developed a very strong and very robust end of day price discovery process which is very unique in terms of receiving prices and being able to market to market rather than market to model or market to
myth. The same people typically we would refer to in terms of CDS market believed in our pricing.

On the other hand, we've been very selective as Kim and Chris mentioned. The risk characteristics in terms of selection of specific names that belong to given sectors and how these single names would fit the initial set of instruments that we started clearing in terms of indices because the initial launch by ICE Trust was based on index clearing services and then we expanded to single names, carefully adding more and more names in every single sector so we could achieve a specific number of single names that could be used for potential hedging and decreased cost upon liquidation if a clearing participant defaults, namely providing portfolio benefits in the sense of index versus single name liquidation or unwinding.

So there are a little bit more technical aspects in the selection process but overall we look at the index, the risk characteristics, their ability again to price these instruments where our
selection criteria involve a very thorough back testing and stress testing, namely given the new instruments that we intend to clear and those that are already in the clearing services, how the new instruments will fit the overall risk profile upon stress testing, back testing, just to see if there is any specific type of risk, correlation risk or extreme risk that could lead to worsening to the overall risk profiles that the clearinghouse will keep in terms of their members.

MR. RADHAKRISHNAN: Matthias.

MR. GRAULICH: Well, I think if you look from a, well, risk management margining perspective, I think a clearinghouse has or faces the same problems as if the business stays bilateral between two counterparties. So basically we look at it from a back end. So what happens in a liquidation scenario? And given the characteristics of the CDS market it's, well, there are, for example, all the series which don't have liquidities or you face always the problem that in a default scenario you at the
clearinghouse have to get rid of the positions.
And now I believe that generally everything could
be cleared but it depends on a commitment from the
market participants and the clearinghouses to act
in such a situation of a liquidation and the
default to provide prices and to, well, be willing
and able to buy a certain portfolio or bid for a
portfolio. So that would mean you need to go for
an auction process. There needs to be some
mandatory element of this auction process attached
to it to really protect the overall economic
framework.

MR. RADHAKRISHNAN: Thank you. Now, we
have two academics here who have given a lot of
thought to this subject and I'd like to invite
them. Kristin Johnson.

MS. JOHNSON: Thank you. I'm very
enthusiastic of the inclusion of the academics in
this conversation. My colleague, Craig Pirrong
and other colleagues in the Academy have been
writing about the necessity of regulation in the
over-the-counter derivatives market for decades,
and we are enthusiastic about the opportunity to
be invited into the conversation, largely because
as Matthias mentions, there are significant
continuing concerns subsequent to the adoption of
the Dodd-Frank Act with respect to liquidation
scenarios, particularly when execution facilities
or derivatives clearing organizations might be
allowed in certain instances to be the recipient
of federal funds in the event that there is a
default of the clearinghouse.

We know that our colleagues at the
clearinghouses have regularly introduced
significant reforms, risk management, and pricing
discovery reforms, that have aided in the
stability of financial markets. And for that we
applaud them. But we are thoughtful about the
responsibility and expectations of accountability
that the Dodd-Frank Act introduces for regulators.

So on that note there are some issues,
at least two that I would raise, as concerns in
the development of regulation for the
clearinghouses. And the first is that the pricing
models and the risk management models are still continuing to be proprietary models, in which case we are hoping that in every instance each of the independent businesses is effectively able to model and manage risk effectively. I think historically there has not been, as there will be, such a level of necessity for regulators to be familiar with and have the capacity to engage rigorously in a robust debate about assumptions -- the underlying assumptions in these models.

MR. PIRRONG: I second Kristin's appreciation for being -- having academics included in the debate. It is refreshing to see such an open debate on these sorts of issues. I just have a couple of comments, and one comment generally is who should be making the decision regarding what to clear and how to margin it. And I think it's very important that the decision be left with the folks that have the information and have the incentive. And, yeah, that's one concern that I have going forward in terms of who has the ability to decide. And I think that the kinds of
criteria that Kim and Chris and Matthias mention here, you know, are crucial in terms of having a good understanding of pricing in the market, having products that are sufficiently liquid. It's not a matter of contractual standardization per se that's important. That's a necessary condition but not a sufficient condition to make something clearable. Instead, it's having the information on pricing and risk that is crucial. And having the people that are ultimately at the end of the day going to be the residual bearers of that risk have the ultimate authority over whether that's a risk that they're comfortable in bearing or not.

In terms of margining issues generally, I just think one thing that's very important to keep in mind with all products, but particularly with CDS, is frequently there's an incentive or a tendency to think of things on a product by product basis or a name by name basis. But when you're talking about CDS, you know, particularly various sorts of correlation risks that are very
1 hard to understand and very hard to get a good
grip on are extremely important and of first order
importance in these sorts of markets. And that's
another sort of issue that I think regulators have
to be particularly aware of going forward.

MR. RAMSAY: Ananda, before we get waist
depth in a lot of the policy issues I just wanted
to ask anybody who has some thoughts on it, in
terms of looking at the evolution of the market
and development as between index products versus
single name CDS or narrow based index, how people
see that progression developing. Will the
prospect of clearing change that? Obviously, from
the SEC standpoint we have a particular interest
in products that can be either used as proxies or
in tandem with an underlying equity. We have a
concern with the whole area, of course, but it
might be interesting to get people's perspective
on how they see the migration of this particular
part of the market developing in terms of
breakdown of product types.

MR. DIPLAS: Yeah. I mean, if you look
at the progression of the introduction of products in the clearing, obviously we have started with indices because they're actually simpler products. They have less volatility and therefore that was the natural product to actually experiment with. I would say that that has gone well and that's why you see the success. And the fact is among eligible participants we have cleared north of 95, 96 percent of most of these liquid indices. So that was where we started.

Obviously, the next step was to introduce the single names which carry with them more risk and that's why the risk models had to be adjusted. I think most seem to be started with kind of regular, you know, models they have used already in futures when they dealt with indices but obviously when we went to single names the models had to adjust significantly.

From a clearing participants perspective we have an interest to maintain balanced books. So to the extent of actually we trade in both indices and single names, we have an incentive to
actually, for example, to introduce the next components into clearing as quickly as possible so that actually our exposure in and out of clearing is balanced. So that has been kind of one of the prioritization schemes with respect to the introduction of single names to try to look at index constituent components.

So and obviously we also start to kind of, you know, with more low volatility names among those. And that's how we're pushing the envelope right now. Obviously, some of the other names that we need to introduce but it will become more complex is when we introduce financials. That's when we start dealing with, and Craig touched on that, the correlation issues basically. How is it basically, you know, Deutsche Bank, Morgan Stanley, CDS, etcetera. So all of those obviously are more sensitive and that's where a lot more work needs to take place.

Just to finish quickly on the comments that people made earlier, I would also agree with them. I think all the thoughts expressed I
definitely agree with. It's very important to remember. Unfortunately, people say economics is a dismal science and CCPs take pessimism to a whole new level because all we talk about is default and it's all about default management. So all it is, when one of us goes under what happens? Do we have the ability to unwind that portfolio successfully? Step number one is to ensure that we have already priced it properly. Step number two is that we have estimated the gap properly. The gap risk properly.

So there is also the second part which is the mutualization element. As we look into tradition in naming that we're going to ensure that actually that name, for example, was started by multiple participants. We don't want to be in a situation for argument's sake that participant A and participant B are trading a name, participant A defaults, and there's only one person in the whole CCP that knows how to price that instrument. So that is an example of something that would be inappropriate to clear.
The second thing is we have to make a guess and that's not a black and white decision obviously -- I'm going through this every day obviously -- is to estimate what is going to be the liquidity of that given name for the life of the product. The liquidity has changed significantly from the beginning when the products are on their own to when it is 1-1/4 here and you never see a trade.

So these are kind of -- I know we're going to get into more details later but these are the kind of issues that basically we have to consider as we look into expanding the envelope.

MR. EDMONDS: Ananda, just to quantify Athanassios point about expanding the envelope, you know, right now we clear 89 single names here in the U.S. and a little over 100 in Europe. I would estimate that as confidence gains as some of the uncertainty around what the rules will be and how these products work together, how portfolio margin is developed from a regulatory status, you can see that list grow. We'll use a round number;
it won't be correct. Somewhere around 300. You know, maybe it's 400, maybe it's 250, whatever, over time, but that will be something that we grow into as we get through that. But that is predicated upon clear understandings of the rules and the expectations from a regulator status.

MR. BODSON: If I can draw some analogies from the cash side of the marketplace. The point about what's liquid today becomes very liquid tomorrow we saw very closely when we did the Lehman liquidation where we had about a 500 billion gross book. The positions -- the treasury positions, equity positions, were all hedged out and started being liquidated fairly immediately. What was difficult were all the corporate bonds. Trying to cover a short TBA bond is not a simple process but with the margin that we had from the liquid positions we were safe in terms of loss protection. But they're very much dependent upon the percentage of liquid positions versus illiquid positions. And as these products come on and go through this phasing that will be an important
consideration in terms of a high concentration of illiquid positions obviously could be very difficult to deal with.

In terms of there was a comment about model reviews, we are working with the New York Stock Exchange Life on NYPC. And I have to say that the thoroughness of the model reviews by the regulators is unsurpassed. We have gone through hoops and multiple iterations of reviews and so on and so forth. So while there may be different approaches as you said, it should remain with those who have the interest in the results. The regulatory oversight is rigorous and thorough and hopefully is consistent across the marketplace.

And lastly, I just want to address there was a point that was made about use of federal funds. I'm not sure if you were alluding to a bailout of a CCP or liquidity which is an issue that goes often confused. We've talked about access to the fed window in order to get liquidity to keep the market flowing. That's not a bailout obviously. That's a loan, usually a
collateralized loan. So I just want to make sure that those two are two very separate issues.

MS. JOHNSON: True.

MR. RADHAKRISHNAN: Thank you. If I could pick up on things that Athanassios said, which is the ability to give prices -- quote prices and the ability to participate in default management. How do we as regulators make sure that those two items or those two considerations don't become barriers to entry for people who want to participate in clearinghouse? So perhaps those who haven't had a chance to speak would comment on that.

MR. CAWLEY: Hi, this is Jamie from Javelin Capital Markets. It's a good question. I would say one thing is that the market is dynamic and as we move through time the liquidity certainly changes on a micro context but also on a macro context. And what I mean by that is certainly the impact of several SEFs, swap execution facilities, is going to help drive transparency and pricing of individual instruments...
and interest rate swaps, and also certainly in CDS. You know, currently today the liquidity is certainly clustered around a five-year swap point. Over time we would expect that that would change as transparency, you know, comes to the market with life screen trading, certainly as it goes down into the one year context and further out into 10 and even 20 and 30 year. So what I would say is that it becomes almost, you know, self-fulfilling. You know, the more things that trade or are eligible to be cleared in a clearinghouse is also assisted by the multiple SEFs that then pop up and start driving and creating transparency in the marketplace.

One sidebar is it's good to note that there's competition between clearinghouses. So there is an incentive, an economic incentive, for people to bring new products to market or to accept more individual names into clearing. That said, it should be balanced against sort of a race to the bottom such that -- and that's where Ananda you come in -- to ensure that that balance is
carefully tendered.

MR. RADHAKRISHNAN: Thank you. I think Jeff will have something to say about the race to the bottom.

MR. GOOCH: We're against the race to the bottom. 

(Laughter)

SPEAKER: Is that a personal or a Commission statement? (Laughter)

I think it's actually a very interesting question about price liquidity and default management Matthias raised and how many products you actually intend to clear because I think the CDS market is in aggregate very large but each individual name actually very small. If you look at the top thousand single names they traded less than four times a day on average. There's probably on 30, 40 names trading even 10 times a day. As Jamie said, you know, there's probably a number of materials. It's perhaps 30 percent of that to the five-year point but they're spread over a number of maturities.
So you're trying to clear what is the individual name that will fare the liquid market. And I think where you get a lot of debate across the industry is how do you defend against that. There's two solutions. One is to only clear the very liquid products, which can, you know, be easy access to pricing. You can run daily cycles, etcetera. You can be pretty sure there's enough liquidity to move the names out.

Or as you start moving further down that curve which, you know, seems to be the direction we're going, putting less liquid product into clearinghouses, I think as Kim mentioned, there's ways of dealing with that. That starts to force you to put commitments on individual clearinghouse members to take part in daily auctions for pricing; commit to, you know, take part in a default situation; to take part in auction to help move some of those less liquid names that the clearinghouse could never realistically trade out for themselves. And as you do that, that puts the onus on the clearing members to be higher and
higher and higher, which tends to concentrate you
on the more professional users, the larger users,
being the only people who can realistically make
those commitments. And, you know, there's certain
parts of the industry that sort of complain about
that in terms of excluding some of the smaller and
midsize players. But I think after the inevitable
consequences, the choices everyone takes about how
much business is going to be cleared, you know, if
you clear very liquid investment rate indices you
can probably run a very different set of
membership requirements and obligations than if
you're trying to, you know, include the 300 most
liquid single names, that's going to be much
tougher.

And I think that's why it gets to be a
very emotive subject because depending on how much
you try to put on, you have to deal with the lack
of liquidity in other means and that in itself
creates barriers. So I think it tends to get a
very emotive subject.

MR. HARRINGTON: George Harrington from
Bloomberg.

I think barriers to entry are really a key subject in the clearing -- in the clearing debate as far as, you know, what are the barriers? And obviously, you know, being in a clearinghouse obviously has its own challenges as far as the default management rules. But also for the, you know, for all the participants who are going to be involved, whether it be a SEF, whether it be an SDR or a clearinghouse or a real-time reporting facility, whatever it may be, all these products, especially in the CDS space, you know, I have a lot of standardized terms as we've talked about. But with that there needs to be access to the usage for the participants of the, you know, the basic standardized information around those products. But then also open access to the, you know, to the clearing facilities.

And when we say open access, obviously I think the race to the bottom is a good point. You know, I think it's almost technologically impossible for everyone to say, well, I'll be
fully interconnected to everyone who comes to the market in real-time. That being said, for participants or major participants, I think that there certainly should be a standard set that open access, you know, among the providers of functionality, whether it be clearing, whether it be execution facility or swap data repository, you know, there's a lot of utility-like items that need to be -- that need to be able to accessed at a fair level.

MR. RADHAKRISHNAN: Go ahead. Lynn and then Wally.

MS. MARTIN: Okay, as the lights are going out. Thank you to the SEC and CFTC for inviting NYSE Euronext to participate on today's panel.

I just want to touch on a couple of things that some of my co-panelists have mentioned today. One around the idea of open architecture, specifically that there needs to be a common set of core principles or a common regulatory framework that governs these things so that we
don't have a race to the bottom, so that there isn't a regulatory arbitrage opportunity potentially created.

But one of the other points that I wanted to touch on is the migration of products into central clearing and how in order for an efficient migration of the products to central clearing what needs to be considered is the way the markets trade today and allowing the markets to continue to trade in that manner. If the goal is to migrate products into a central clearing platform then in an efficient manner what should occur is that markets need to be allowed to trade as they are today to some extent.

Moving to central clearing leads to additional standardization and that potentially could make the market models that are adoptive for certain products today evolve in the future to more of central order book products. But to force the products into a central order book mechanism when they generally don't lend themselves because...
nature of the products could potentially affect
the liquidity of those products.

MR. RADHAKRISHNAN: Sorry, Wally wanted
to say something.

MR. TURBEVILLE: Thanks. Yeah, I think
it would be a good time to -- because there's
several concepts floating around here that need to
sort of be tied together. Craig was talking about
the motive for -- the decision-making process for
including instruments in clearing and it has to do
with this is a law that depends on the
clearinghouses to make decisions to -- for its
success or failure. So what is I believe
critically important is that the clearinghouses
who offer these services do have the motive to
advance the principles behind Dodd-Frank. And in
thinking about that I think it's real important to
think about what the real decision-making process
is about. When we say something is -- doesn't
have the risk construct to qualify for clearing,
what we're really saying is that there's a
decision being made that the residual risk beyond
what can be collateralized is somehow inappropriate for redistribution allocation beyond the collateral to various members of the clearinghouse. That's what we're talking about. So it's a question of reallocation of that excess risk.

And the decision between an instrument -- if an instrument is going to be entered into and cleared or uncleared, if it's uncleared it's in an environment where all the fine attributes of clearing, like standardization, clearing causes standardization to occur. Like transparent management of the risk, margining of the risk in a proper and timely way. All those things don't get done.

So I think the challenge is not simply to live with the fact that those kinds of limitations are on us but I think beyond ways, beyond just putting up more collateral, beyond some of the more obvious ways to try to bring as much product into the clearing environment as possible and not do a race to the bottom but
rather try to imaginatively think of ways that we can bring as much into the process as possible without racing to the bottom, without creating systemic risk.

MR. RAMSAY: I was, your statement just triggered something I was trying to ask generally which is -- make a statement first of all which is kind of an obvious one. The statute has put the regulators in -- sort of in the middle of this dynamic in terms of figuring out what gets cleared and how much and how one makes those determinations. And you know, so one of the things we're going to be dealing with is trying to come up with an appropriate framework for making those kinds of decisions. As a threshold matter, for example, for determining that if something is -- can be cleared, if it's approved by clearinghouse and approved by the regulators, improved by clearinghouse to trade, that that product or economic equivalence must then be cleared.

So I guess one question is do we allow
for bilateral trading to continue side by side for at least those class of things that we have determined commercially can be cleared? And there's a mechanism for doing it so I'll just throw that one out as a first.

MR. CAWLEY: I would say -- it's Jamie from Javelin again.

I would say that if you allow, and certainly, you know, there are instances where bilateral trading should continue, one has to be very careful that if you allow that there should still be a significant impetus for the market to continue to be centrally cleared. So where we sit, if you look at the credit default market and North American credit, you see that index which is essentially three or four products, are 40 percent to liquidity on any daily basis. They are comprised of 248 constituent names. Specifically, we believe that they should all at some point be cleared, be it 85 names today, bootstrapping 50, 60 names over a successive period over the next two to three years, such that 248 names at least
are traded are clearable.

There's about 450 to 500 credits that trade actively in North America. I think if you capture the 248 names and index, you're capturing approximately 60, 70 percent of the daily volume in the credit default swap market today.

Obviously, as you trail out from there, there are credits that don't trade that frequently. I would say that one has to consider and be mindful that volume does not mean or the lack of volume in a particular trade or a particular name does not mean that you cannot price it. As any credit trader will tell you, it trades on a curve. So whether it be a five year, you know, take a GMAC curve or Fannie or Freddie, there are thousands of issues that get priced on a daily basis. And it's not necessarily mark to myth; these are legitimate prices where traders put risk of balance sheet at work every day as they provide liquidity to the market space.

So I would be mindful that over time the market should drive towards clearing. And to the
extent that you allow or there is a necessity for bilateral trading to occur, you should somehow handicap it with some type of capital, you know, the appropriate amount of capital to, as an incentive let's say, to ensure that there's no gaming of the system such that names unnecessarily sit outside the cleared context.

MR. DIPLAS: I'd like to take a second to explain what we have in place in terms of trying to mark conducts and why we have made those choices. I'm following up on what Jeff said earlier. If you look -- even if we had made a decision to just go with the most liquid instrument out there which is the only one investment grade index, that liquid as we know it could trade a thousand times a day. But in about six months time when it becomes (inaudible) the volume will drop by 90 percent. In another six months, that volume drops to practically zero, to a few trades a day. Okay? So that is why even if you start with the most liquid instrument it will become illiquid eventually. It's the aging
process. Unfortunately, we all have to go through that. (Laughter)

So we have to have the confidence, however, that we mark this thing properly. And the mechanism that has been introduced is actually a quite stringent one and onerous perhaps you might say but it is fundamental. If you look at the curve, and we go back to single names, when we talk about the name trading, in name trading ten times it means there are 40 points on this curve and there are 10 trades in one of those 40 points. Five of them are most of the time with the five year. The other five get distributed among the rest of the 39 widgets.

So what do we do? We will not observe this. And as James said, we will have to price some of these things on the curve. So what do we do? We have put an obligation on the clearing members to basically give two-way prices which can be actually executable two-way prices in order to give the confidence to the clearinghouse that they know what that market is. Because, remember, even
if it trades on a SEF, the five year might trade
but you will not see the two year.

So just to give an example, if everybody
says on a given day they mark the two year at 99
and 101, the mid market is 100, and I say I'll
market 199, 201, I'm off clearly, either because
for some malicious reason or because I don't know
what's going on. But what happens is in that
process I get penalized by cross trade. So that's
why I have to basically take that responsibility
to take the trade on. Now, the benefit of that
process is that it introduces honesty and
information into the process and the next day or
so my manager will know that actually I don't know
how to mark these things. So probably he will
tell me to actually go fix it. So that is the
process. It creates a virtual cycle to actually
give that information. So that's what we have put
in place.

Now, that as Jeff said, is a very
onerous process. So whoever is participating in
that has to stand up and be subject to that
process. And that's why I said that if there's only two people doing that, clearly that's not good enough. It's going to fail. We need to have a minimum mass of people actually trading these things. And (inaudible) we have looked (inaudible) I'm looking at the CCPs here who have wanted to have at least four people that actually provide prices in that scenario. So that's kind of a number.

But I have to be careful. We have to be careful. This is not going to go away. SEFs or no SEFs, it's not going to go away. SEFs will not create liquidity beyond what clients have to do. The needs of the clients are what drives the liquidity. And if you think of clients, I would say think of them in two ways. There's the people that actually are the frequent traders that will trade around the five year. That's why you see so much of the volume of the five year. They always want to trade the active conduct. And then there is the others that basically they're the buy and hold customers. They will buy -- they hedge a
bond and they buy CDS with it. As the bond ages
the CDS ages. So those guys will never trade it.
But we need to price remember everything in the
clearinghouse.

So that's the last thing. Keep in mind
these processes have to be strong. And whoever
comes in has to stand up to fulfill that
obligation.

MR. BENISON: Just, I fully agree.

MR. RADHAKRISHNAN: Let -- Kristin
wanted to say something.

MS. JOHNSON: Thanks so much. I want to
go back to the original question that seems to be
on the table in that with respect to what we can
determine based on what the CCPs regularly clear
to be eligible there seems to be a question about
whether regulation mandates whether we interpret
Dodd-Frank and read the congressional statute to
mandate clearing of those instruments. And I
think there's a parallel question within the
eligibility and ineligibility discussion. And let
me explain what I mean by that.
It was Lynn who mentioned that there would need to be consistency as to how we treat -- how the regulation treats the various clearinghouses and examines them. And there will be real challenges here because as the CFTC and the SEC come together to attempt some form of harmonization. There are historic principles versus rules-based questions that will arise here. And so in looking at the question of the requirement for clearing of what the market has deemed to be eligible -- eligible names or eligible indices or other products that clearly the CCPs are regularly clearing, I won't resolve here whether there is a mandate that those must be cleared. But I think that there should be some concern about what the congressional intent in the statute was. And in sorting that out, however it works out, I would just echo Lynn's comments that there would be some consistency with respect to margin and collateral setting, with respect to clearing those trades as per what the CCPs are doing for those specific transactions. Right?
So I think one of the greatest overarching concerns was the shadow trading of things whereby pricing might have been inaccurate and margins and collateral requirements were obviously inaccurate. So allowing eligible transactions, transactions that the CCPs have clearly established in the market that they are willing to clear, allowing those eligible transactions to occur outside of clearinghouses does leave an onus on the regulators to be very active in assessing margin and collateral requirements and it creates a market surveillance -- it creates a gap in market surveillance, I believe, based on the reality of the resources, human resources available at the federal regulatory level to oversee on a daily basis the mark to market evaluation of those transactions that are not cleared.

MR. TURBEVILLE: I believe there is a mandate, but it's -- the fact of the matter is that the meaning of Dodd-Frank is that as much as can, within the bounds of prudence be cleared,
should be cleared. I think that's obvious from things that clear. That's obvious from the statute. And I think clearing is a remedy to a problem that was viewed as in existence.

As to items that aren't cleared it also suggests strongly that the process of clearing and the ways to manage the consequences of default are a superior way of going about things than in a bilateral world. Ergo while clearing processes suggest the right kinds of approaches to measuring risk that in an uncleared context, particularly with regard to liquidation of positions, the appropriate amount of collateralization should be in excess of that which is required in clearing because conceptually it's a different world, the resolution of a default, and it's not as inefficient as a process oriented process.

MR. RAMSAY: I suppose that if one accepts as general proposition, you know, the idea that there's a mandate that if something should be cleared or can be cleared it should be, to Athanassios' point he made recently, that, you
1 know, products can have a lifecycle, too. And so,
2 you know, demand, market demand, may ebb and flow.
3 You may have a product that where there's enough
4 market demand at one point in time that there's --
5 that would justify even mandatory clearing. That
6 might not be true in perpetuity. I would assume
7 there might be a point at which that mandate might
8 no longer survive or be appropriate for that
9 particular product. I suppose if the
10 clearinghouse no longer has the demand it could
11 stop trading the product and then the question I
12 suppose would be is there -- does the regulatory
13 mandate then fall away?
14 Anyone?
15 MR. DIPLAS: I don't think we can
16 declare it actually. The reality is if we put
17 something in the clearinghouse it's going to stay
18 there. It's very difficult to declear something.
19 So we think we need to make that decision once and
20 then it goes there. And then it's going to stay
21 until it matures.
22 MS. TAYLOR: I would agree with that
finances that trades once they are cleared would
be difficult and probably unproductive to unclear
positions that have been cleared or to force those
to be uncleared. But I think that there could be
a circumstance in which a particular product was
cleared for a period of time and then the
clearinghouse could determine that the service for
that product would be extended only to liquidating
trades or something like that.

I think it would be unlikely. So I
think we should be making good choices on the way
in. But with respect to the question of whether
or not everything should be forced to be cleared
if a clearinghouse makes a service available, what
I would say is -- I'm not the right person to
evaluate whether there is or is not a mandate in
the legislation. But I think that the markets are
best protected and the participants and the system
as a whole are best protected when the structure
that we put in place is one that maximizes the
amount of available liquidity. An so I would
suggest that to the extent that there is
flexibility in the regulations that the regulators
would follow a policy of trying to kind of first
do no harm and over time I think the existence of
the CCP model and the existence of the SEF
incentive will tend to increase the available
liquidity and the visibility of that liquidity.
That's not something that's going to happen
automatically over night. And so I think there
will be a transition period during which we should
think very carefully about doing the transition to
clearing or to SEFs in such a way that there's the
least disruption possible to the available base of
liquidity that exists.

MR. GRAULICH: So liquidity was
mentioned many times now as a key criteria whether
a product is clearable or not. And I fully agree
with what Athanassios said and this is a built-in
problem with the indices with the old series. So
if you have a new series, the old one will become
illiquid so it's difficult. And there is no
liquidity in a default scenario for those products
so you, as a clearinghouse, are not at all in a
position to liquidate those positions of the old
series because there is no natural market
liquidity.

And what Athanassios described, the
mechanism which is introduced now that the market
participants who are in a position to do that are
while voluntarily providing prices to the
clearinghouse to do a proper evaluation of those
positions, it's very important and it's one piece
to the puzzle. I think if it comes to the
liquidation, then it is important that the dealers
who provided the prices stand by their prices. So
they have to have -- if that system should fly,
then they have to have a certain obligation to
stand by their prices and pick up some of the
portfolio of the liquidating -- of the defaulting
member. Of course with some discounts reflecting
the size of a defaulting member and some well
spread increases which you usually observe in a
default scenario, but I think that is something
which needs to be added to that approach which is
currently there.
An alternative I think, and if we look at the Lehman default and how Eurex, which is predominantly exchange trading, so here you have a -- the future system that you always have the high liquidity in the closest three months expiry and every three months there is a big roll into a new series. And I didn't think it fully through but perhaps that would be something which could be an alternative way to not, well, make those old series illiquid but kind of roll those old series into a new series which then has a liquidity again. I don't know. I'm not a market expert and Athanassios or others can comment better on that, but that could be an alternative having seen that it worked on the futures side very well.

MR. DIPLAS: That is -- it kind of happens already. That's what I was saying. Half the trades let's say are old. But then you have the problem with the other half. I'm making up the half, but more or less. But the others don't and they basically age. And the advantage of futures, you're very correct, is that they
naturally expire and therefore you never have the aging problem. So that's the thing.

There's only one word I would correct in what you said. I agree with everything else. We don't voluntarily provide prices; we contractually provide prices. (Laughter) And also for default management, we contractually have to step up exactly as you said to actually take and unwind the defaulted portfolio. In every other respect I agree with you.

MR. IVANOV: And just to expand on what Athanassios is mentioning, indeed our participants, they provide prices. These prices are such that they stay behind. Actually, we created something we feel that is almost unprecedented in the CDS market, namely having a price discovery process that provides prices at nine points on the curve even though typically people will look at the five-year point as the most liquid. In terms of managing default enrolling, it is about risk management policies and practices and how risk management is executed.
But once the serious roles or it just moves from the most liquid point, definitely the liquidity charges would and should and must increase. On the other hand, in terms of default, the default management approach is to really look at hedging with the most liquid points on the curve and then auctioning the full portfolio rather than just sitting on these illiquid positions that they're very difficult to move. But the price discovery process is indeed very robust. And we've seen tremendous improvement in terms of market consensus and prices that we generated throughout the last 16, 17 months in terms of index and single name pricing.

MR. TURBEVILLE: Correct me if I'm wrong but I think what I just heard is I think a very sort of interesting point. As the liquidity deteriorates in this set of instruments, what's happening is that a set of the participants in the clearing enterprise, the members, are actually providing liquidity at a price in order to support the credit system that's in place. Okay? That
principle is the principle that I was talking about earlier which could very well -- I think that's a tremendous result. I think it's a sensible result. It's a way to increase the amount of instruments that can be cleared, and I think it has applicability far beyond that specific situation in terms of instruments that maybe cannot be clearable given the judgments that are applied by clearinghouses at the outset. It's a principle that can be built on and used to actually fulfill what I think is the intent of Dodd-Frank, which is a mandate or to clear as much as you possibly can.

MR. BODSON: There is, sorry, there's one other element we kind of forget here. We're in the Trade Information Warehouse. We have 3,000 reference names. So there's two elements here. There's an element of maturity curve, but there's also the element of there's a lot of names out there that, you know, will bespoke or a one off type of transaction. So that factor in terms of everything getting cleared, there's another part
of the depth of the market that has to be taken into consideration.

The comment about the lack of standardization is I think, as Athanassios said at the beginning, there's been a huge move towards standardization. Ninety-eight percent of our transactions are gold transactions electronically confirmed. And you do that because of standardized terms. So regardless of what's going on in the clearing space or the SEF space, at the end of the day obviously we've been a very strong proponent of standardized reporting and aggregative reporting so there is transparency, there is a simple source of information that the regulators and the market can go to.

So the lack of something being cleared does not inherently mean it's not standardized, not reportable, you know, somehow disappears into the ether of Wall Street and never is seen again, the activity is standardized. The activity is being reported on in both a public manner and to the regulators.
MR. RADHAKRISHNAN: To counteract declining liquidity, is it appropriate to have a ratcheting up of margin requirements and/or default fund requirements. Because after all, one of the concern about the liquidity is what happens if somebody defaults and how do you manage that position? So I'd like some comment on that.

MR. DIPLAS: It is appropriate but it's already done actually. The CCPs themselves, I'll let them explain it. They already have -- they look at, you know, the bid offer in the market and based on that they basically determine based on the depth of the market what the right liquidity charge is basically. So as the index, even an index that is liquid now ages, we do pay higher margin than guaranty fund contributions. So that's already done. And I think that's the only way you can deal with it. Remember, the margin has to reflect the gap risk. The gap risk is higher for a conduct that's more liquid. So I think they're doing that already. So conception of the framework is correct. It's a matter of we
can discuss the calibration whether they give the right numbers or not but conceptually I think they're approaching it the right way.

MR. BENISON: That's also going to be -- it's going to impact the liquidity charge but it's also going to impact the concentration charge. Right? So the concentration charge is going to be based on how much you can move compared to the size of the position. So it should be factored in.

MR. GOOCH: Yeah, I'd almost have to give the CCPs a little bit of wiggle room to make their own decisions on some of this stuff because I think if you look at the indices at the moment, as we roll an index we take 125 names and we decide only 110 of them are still very liquid and that's the new index. So if you look at an index from a few series ago, most of the names within that index are still liquid and still actively traded in the new indices. So whilst the index, the package itself is illiquid, most of the risk it contains is still liquid and can be managed.
But you could get a situation where, you know, radical movements in the global economy and the names change very fundamentally, so you could end up with a very old index that has nothing in common with current single names on liquid or current indices. And that would be a very different risk management problem. So I think it's very hard to draw a general solution. Most indices themselves age gracefully and change slowly over time and the liquid they represent is not that illiquid. But we can't guaranty that in the future. There has to be some sort of let out for the CCPs if they're left with a situation where something doesn't trade at all in any format then perhaps there is a different set of solutions.

MR. BENISON: Except, Jeff, the one thing is while the names themselves, you know, at the current on the run point will continue to be liquid, the names at the same maturity as that off the run index rolling down the curve are going to get less and less.
MR. GOOCH: Yeah. You certainly get a double factor of liquidity. You go the aging and the other fundamental liquidity. I agree.

MR. EDMONDS: Yeah, I think what -- I was going to bring up the same point that Tom did but, you know, think about concentration at the end of the day. There could be positions that are in the clearinghouse that someone pay whatever it is they need to pay in order to terminate the transaction. It goes away and there's no longer any risk. That could definitely change the concentration profile of who holds the positions left and the residual contract or position within the clearinghouse. That change at the end of the day, you know, we're going to monitor in real time. I'm sure any relevant CCP would do it in some similar manner. But, you know, it seems to me like there's this idea that we don't want to clear more. I mean, we're commercial interests. We have shareholders. We want to clear as much as we possibly can clear at the appropriate time. The balance of risk we have is making sure we do
it prudently.

So there's not a desire here to go, gosh, you know, we only have 89 single names or, you know, 300 of whatever -- can we get to 3,000? I'll defer to Stan on that one. (Laughter) It is something that at the end of the day, you know, that is the motivation about the structure of the commercial entities that provide these services that if we were to begin, and there have been some comments around, you know, whether or not there should be more utilities versus, you know, for-profit entities, it's problematic because if you make that a less than for-profit utility you may end up with a situation where there is no motivation to go out. It's not the race to the bottom because you still have the balance and it's incumbent upon the regulators at the end of the day to make sure that we don't do that as an industry. You know, no one wants to sit and run a clearinghouse to manage the biggest default and not survive for the first time in history, and no regulator wants to sit in their chair going guess
what? It was on my watch that that happened. So, I mean, there is some intrinsic piece. And certainly, you know, the counterparts, whether trading counterparts of the market or clearing members don't want to be party to that either. So there is an opportunity for in the right spirit but it's not something that we want to clear less. And that shouldn't be the presupposition people operate with.

MR. RAMSAY: Your question, you know, there was a question I was thinking of maybe saving for later on but I'm tempted to ask it now in terms of this tradeoff between providing access, both in terms of the amount of cleared products as well as access to participants versus sort of good risk management. That's part of what the statute requires us to think about and both of our agencies recently put out rules on that point on dealing with conflicts of interest and dealing with them by proposing specific requirements in terms of limitations on ownership as well as board composition for those agencies in order to try to
balance those two factors as much as possible. We are in the public comment process with respect to those particular rules. So if people have any general thoughts about that tradeoff and how to approach it, or any more specific comments on those rules, from a regulatory perspective we'd be happy to hear them.

MR. BENISON: So I would say that first of all I think there are a number of different sets of conflicts of interest you have to worry about. So to the point Chris mentioned before and I don't think this is a problem in any of the current clearinghouses and the current constructs, but there is, you know, the structure of a clearinghouse is you have now private for-profit entities that are basically managing the capital of the members because it's the membership of the majority of the capital. Even though the CCPs all have some stake at risk, it's really a sliver compared to the pool put up by the members.

So you have one concern which is, you know, they are basically earning fees by putting
members' capital at risk. So you have to sort of watch that. From a members' perspective, I think the way you have the ability to watch that is you have some say over how your capital is risk managed. And that's through the risk committee. Now, that's not to say that end users shouldn't have transparency into that process and a say in that process or independence, but I think it's a dangerous situation. You have to think very carefully about saying you're mandated to clear, you're putting your capital up to be managed by this clearinghouse, and we're going to reduce your ability to impact the risk management of that. I actually think from a risk management perspective the members are aligned with trying to appropriately risk manage that.

MR. DIPLAS: I would agree with what Tom said. And perhaps if I can say the same thing in a little bit more -- in a slightly different way. If you look at the traditional capital --
corporate capital structure, you have the equity holders and you have the debt holders. It's a
very simple structure. The equity holders make the decisions but they're on the hook because when the moment there are lawsuits they will be the first ones to take a hit and then the debt holders take a hit. And usually they build some covenants to protect them, etcetera.

In the CCP, that order is reversed. Okay? If we look at a waterfall, the default clearing member takes the first loss, then there's a thin layer that the CCP takes a loss, but then it's the debt holders that actually get wiped out potentially completely but the CCP could still operate. So that reversal of that capital structure is very fundamental. And the way you can protect the interest of the debt holders in that respect is to involve them in the risk management decisions. And for us that is -- the risk committee is the most important element of the clearinghouse to make sure we get it right. And I believe in every other respect the (inaudible) line. And the last thing is alignment of interest, like Tom said, to ensure -- you have
to ensure that you don't have a CCP, a new CCP and none of the ones from this table unless you can make up a new one comes up. I want to clear this new product. Nobody else clears it and then you have to mandate everybody to come to me. You cannot have a captive marketplace basically in that respect. So again, it's up on the regulators to ensure that doesn't happen.

MR. RAMSAY: Professor Pirrong.

MR. PIRRONG: Yeah. This debate has frequently been framed in focusing on conflict of interest but I think it's more important to focus on alignment than incentives. And I think that that's the point that's being made here. And there's also an issue with membership and access to the clearinghouse and things of that nature that's very important. I mean, there's also been a focus on sort of the product-specific nature of default risk. But essentially, default risk depends not just on the risk of the product but also the risk of the firm that has the position and the interaction between those two things. And
1 when you have potentially very heterogeneous
2 membership of a CCP and you're essentially not
3 adequately taking into account the specific risk
4 associated with a particular member, that can lead
5 to, you know, conflicts within the exchange or
6 within the clearinghouse, governance issues,
7 governance conflicts, and also, you know,
8 essentially inefficient allocation of risk across
9 the members. So, you know, I think these access
10 membership and governance issues are very
11 important and will really determine how well this
12 mechanism works to reduce the kinds of risks we're
13 concerned about.

14 MR. TURBEVILLE: There's no doubt that
15 everything that's been described here is
16 absolutely true, but it's a two edge sword. I
17 have no doubt and I think many have no doubt that
18 there have been instances -- I've been involved in
19 instances -- where the membership of
20 clearinghouses, especially in launching a new
21 product, is tremendously influential in how it
22 gets launched beyond merely concern about the risk
of the clearinghouse. It happens.

And I think the other thing that's -- so
the governance issues are very relevant. Even if
nothing ever had happened just for appearances
sake, you know, I think for the credibility
because clearinghouses now are an instrument of
policy, whether you like it or not. It's
happened. It passed.

The other thing that's quite important
is governance issues. But you're right, it's the
risk committee. And I think very significantly,
again, even if you're just concerned with
appearances, I'm concerned with substances but
appearances. That independent representation on
the risk committee in a robust form is a very good
thing. That's not to say that members of the
clearinghouse shouldn't have a lot to say about
how that works. Their capita is at risk. But
this is an instrument of policy as well so that
robust representation on risk committees is
essential.

MS. JOHNSON: If I could chime in just
with some specific corporate governance concerns that come out of a lot of the academic literature and study of securities regulation over the last at least decade, certainly strongly influenced by Sarbanes-Oxley and in addition to that the number of acts Congress adopted in the financial crisis, there clearly is a new federal focus on corporate governance for all types of businesses. But with respect to risk management governance involving businesses that are effectively the arteries or nervous system of the national and international economy, I think there are genuine issues that we now find ourselves facing.

I'm going to speak to some specifics because I think this is an important opportunity for what has been in legal academia conversation we've had to bring to the table. With respect to corporate governance in the CCPs or derivatives clearing organizations or SEFs, however we look at it, there are -- it is tremendously critical. I guess I should just say that independence with respect to directors and perhaps ICE has some
unique structural benefits built in in its direct oversight, regulatory oversight, making it distinct from other CCPs. But in general, the independence and competence with respect to risk management oversight on boards of directors is increasingly important. And we've highlighted independence historically but I think we see now some new ties to expertise in the ability of independent directors to oversee risk management policy decisions and to have authority to pass on the quality of those decisions inclusive of the effectiveness of the models to consider highly significant but low probability events with respect to default.

In addition, I think with respect to the risk management committees, there will probably be I expect coming out of the regulation, if not in this instance than I think the academic world certainly anticipates it, requirements with respect to independence by service of risk management committee members. And this is to isolate or potentially evade concerns regarding
pressure on those committees to respond just as
someone has mentioned to new product requests in a
manner that might prioritize profit over what
would be a protective or defensive position for
the business itself.

In addition to that I have certainly
seen in literature a number of commentaries about
ties between compensation for directors to the
performance of the CCPs and some concerns about
how those linkages might create cause for concern
and certainly fall within the general parameters
of the conflict of interest discussion. There are
also concerns about eligibility of clearing
members as Craig mentioned that we are at least
very thoughtful about and we're sure that the CCPs
themselves and the regulators as well are
thoughtful about.

MR. GOOCH: I would like to, if I may,
just step in and echo Craig and Kristin's
comments. The fact is that CCPs, you know, are an
instrument of policy in a post-credit crisis
world. If clearing is going to be successful, and
1 despite the fact that you're putting capital at risk as you contribute to the funds, the fact is that you do need a certain degree of transparency in a corporate -- in the government's level. And access. You need to have independent directors. We need to know what's going on as a marketplace away from, you know, simple profit motives of a clearinghouse.

And to dovetail off that I think it's important when you look at FCM eligibility requirements specifically that the market or the CCP itself should not just focus on its FCM membership today but also ask yourself what other FCMs out of the, you know, 50, 100-odd FCMs do qualify from a capital standpoint and who can also share the burden in terms of providing prices and putting their capital at risk in a default scenario. So especially in light of the fact that you have a certain degree of correlation risk that may exist if you just pick from one pool. So there are FCMs out there today whose core business is clearing, who represent large away from the
clearing of CDS in other market contexts are represented her -- well capitalized or are well capitalized entities that fulfill the specific capital requirements of both ICE and the CME and Eurex. But we need to be mindful that they be given access and innovative ways be thought of because some of these guys don't necessarily have their own dealing desks but they can still provide prices in the end of day process by doing joint ventures, for example, with dealers who don't clear for themselves, for example.

So in essence, you know, from a clearing standpoint, yes, you are private enterprise but, you know, one thing we need to be mindful of is you serve a public need in the success of clearing and the lessening of systemic risk.

MR. HARRINGTON: I think Jamie makes a good point there. One of the things that we're seeing as far as a structural change in the marketplace right now is the move from just interdealer clearing, which has been, you know, going for, you know, I guess over a few years now
on products like ICE, but then if you look at the interest rates there's been clearing in the dealer to dealer market and interest rate swaps for a number of years. The structural change taking place is bringing the clients to the table as far as allowing clearing in the client to dealer space, the buy side, the sell side space. And that's where the access points really, really start to obviously multiply and the importance of it really increases.

And I think Chris makes -- Chris commented on as far as the utility nature. I completely agree that, you know, having utilities in place will, you know, most often decrease innovation, decrease efficiency, but sort of the key is to getting directly to a clearinghouse crediting and getting directly to a SEF or getting to a swap date or a repository to get things like data or end of day data that provides transparency to the market, that's where the issue really, really lies. So as we've seen, you know, CCPs in the OTC derivative space for a number of years
now, the data that's out there is almost, you know, is very difficult to gain access to. And that's what I think the larger community is really seeking, is the ability to review that data. Or even to participate. So actually getting participation into those CCPs is sort of what people are looking for.

MR. RADHAKRISHNAN: Lynn and then --

MS. MARTIN: I just want to make a couple of points. Number one, it's our belief that numerical limits do not necessarily tie to voting rights on the board. So hard limits don't necessarily represent the voting rights. When you think about the governance of exchanges, DCMs, DCOs, what's more important is to take into account the views and give an equal voice to those views of different market participants. So give a voice to the independence, give a voice to the dealers, give a voice to the buy side, give a voice to the exchange management, and have that be equally weighted as opposed to have hard numerical limits governing that.
In order for us to facilitate a smooth transition to central clearing which is the key objective here. What's going to be most important is that we work together, that the exchanges, the market participants, both the dealers, the buy side, as well as the independents, all work together to define principles that will facilitate the efficient migration.

MR. RAMSAY: Yes. Please go ahead.

MR. BODSON: As the representative of the benevolent monopoly in the marketplace, a couple of comments. One, I do take umbers that utilities aren't innovative. I think we have people who are pushing the edge in terms of systemic risk in taking on issues that others have not taken on. So I'd love to have you come by and talk to us anytime you want and we can explain some of the things we're doing that are very unique, such as the Trade Information Warehouse which was created out of the industry working with the utility to create something that was incredibly innovative and has really spawned the
growth in this marketplace.

I think the comment that was made, as everybody knows, we are a primary user. We do have independence on our board now. But there is this interesting tension between the alignment as everybody has talked about. We have members, we have owners, we have boards, we have management, we have governance. And as the point was made, none of us want to have our name on the biggest default that ever occurred. None of us slept for many days when Lehman happened because none of us wanted to be responsible for the collapse of the financial markets.

So there is an alignment of interest, but there's also a tension. There's a massive tension between our directors, who happen to be, as I said, primarily Wall Street firms. They have a very strong interest, again, of not seeing us fail. So we may be a not cost utility, so we may not have the profit motive balance that my colleagues on the ICE and Eurex and CME may have, but nevertheless, I think people, when you get
into the CCP space, yes, there are profits to be made but more importantly there is a role to play, a policy role to play that is felt up and down the line. So you either are aligned to do your job properly or that tension comes to the forefront very, very quickly. Be it the regulators, be it the governors, or be it the members. None of us want to be involved in a collapse.

MR. RADHAKRISHNAN: I'd like to ask a question about processing. What improvements have been made in trade processing and reporting to repositories? And what more can be done do you guys believe to the CDS market?

MR. GOOCH: Shall I pick that one up? I think, you know, trade processing for CDS has come an enormous way over the last sort of five years. You know, when I think it first came to sort of public forums and regulatory forums we used to spend weeks confirming trades, enormous manual processes, backlogs -- I've never had to use that word but backlogs and piles of paper on desks. It was extremely unpleasant.
I think what the industry has collectively done over the last five years is move to a situation where a lot of the basic problems in processing have now been solved. We've got, you know, over 95 percent of all the trades being electronified on the day, being confirmed on the day, pretty much high rates for the inter-dealer business. So predominately now in the CDS market we do have electronic records, we do have trade day processes which I think put us in a much stronger situation than we were historically.

The focus over the last couple of years has really been two things. One is looking at that gap of some of those very complex transactions that can't be electronified easily and making sure they're still available for regulatory reporting. This is something called the bronze record process but it's been a lot of work to make sure that the Trade Information Warehouse that Mike runs has 100 percent of the credit default swap. Not 98 or 99 because it's the 1 percent that hurts you at the end of the
day. There's been a lot of work to make sure that everything is available, so I think we are now in a situation where from a regulatory perspective at least you can go in and look at everything that's been there. We've done a lot of time in this work. Where people are now sort of focusing is saying, okay, what are the residual processes which still create delay or risk. And, you know, we've done a lot of work on innovation consent over the course of the last year. That was a process that still was very separate and e-mails and Bloomberg messages and things that needed to be electronified so that's been worked through. People are increasingly focused on allocation delivery from funds to sell side firms because that's something that does create delay. It's probably accountable for most of that few percent that doesn't go through on trade day.

So I think we're put in a position now where the trade day process works very effectively to agree to bilateral trades on the day. Where I think we may need to go now is to two things. One
is to look at the whole clearing process. You know, we're in a situation where interdealer clearing happens five days after the trade and that's something that people are now working on to try and fix. Making sure that everybody has access to those processing solutions because I think as buy side firms want to clear, clearing brokers are getting involved with historically not being connected. Some of the new firms that Jamie mentioned getting involved in this market that have not historically been involved, that network is growing from 2000 touch points now, is growing very rapidly to include all those new participants to make sure they have access to those solutions. And I think that's very important to give those low cost access, access is unbundled from other products and services, they can uniquely decide which clearinghouse they want to work with, which SEF they want to work with, how they want their trade processed and not forced into making decisions based on how their services are bundled up between SEFS, CCPs, data companies, other
things. That's important.

And then some of the post trade activities. I think the thing that makes credit default swaps hard, everyone kind of says well, they're a complex product compared to interest rate and a very simple product compared to interest rate. On the trade date, post trade date activities, credit events, restricting events, and there's been a lot of work through ISDA to try and standardize the way they're processed. And I think that's probably where the residual risk probably still sits.

MR. DIPLAS: I would agree with that. I mean, I think the asset class has been electronified more than any other asset class right now. So anything we change right now would be marginal. What is going to be the next big change in my opinion is as we build the SEFs, is the connectivity between SEFs, CCPs, and FCMs. Those pipes are not in place because since we don't know what the big piece of the puzzle that is missing is the SEFs. So I know you're going to
have to go through a pile of applications, I don't know how high, but then when that is in place we have to build those pipes. And that's fundamental. And I think we need to work together both as we've done before with industry and regulators to ensure that we actually don't kind of rush this job. It's very important that we do that infrastructure right because we have a unique chance to actually kind of wipe the slate clean right now and do it properly. And I think in the past we had rushed things and then we had to go back years later and fix them. I think now is the chance to actually make sure that connectivity is done properly. I agree that it should be, you know, we have to build multiple access points and everything else involved for kind of equal access. In every other respect I would agree with Jeff but I think this is the biggest challenge we're going to have over the next few months or year.

MR. BENISON: I would just -- if I could just add on Jeff's comment about life cycle events, which I think particularly for credit is
pretty important. You know, before -- prior to having the Trade Information Warehouse you would have everyone sort of processing life cycle events themselves. So when the index -- when you had a credit event in one index and it dropped down everyone would come up with their own factoring. Bloomberg would come up with a factoring and it would take about, you know, a week to two weeks before everyone's factoring got sorted out to the right decimal place.

So one of the benefits of the Trade Information Warehouse for credit is you have one place that's handling the processing of all these life cycle events, whether it's successor events, credit events, whatever it is. And that's particularly important for this product. And I think if that does get broken up then we've got some other work to do around how to coordinate across that.

MR. CAWLEY: Ananda, if I may, I'd like to just echo Athanassios' comments in terms of SEF connectivity. One thing is it's true. We should
have real time and some SEFs actually are building
or currently have real time access to clearing.
It should certainly be agnostic. It should
certainly be fast and low cost. One of the
things, and it's interesting listening to Tom and
Athanassios talk about the post-acceptance
clearing concerns and event processing after that
trade has occurred. One of the things from a
future SEF that we're looking at right now, which
I think requires market and industry focus frankly
is what happens from the point of trade to the
point in that period between trade execution and
acceptance into clearing? And Athanassios is
completely correct. What we're looking at, and
we're beginning to have conversations as a future
SEF today is considering the role of SEF
connectivity to the FCM on a pre-trade clearance
basis such that, you know, the notion is you take
a trade, you offer anonymous execution between two
parties, you submit both the buy and the sell to
the CCP on a symmetrical basis, which is currently
the workflow with the CME, for example. What
happens if one side, the FCM declines the trade because for whatever reason. So what do you do then? Does the SEF step in to guarantee the trade? We would prefer not to. So how do you get around that?

And the good news is looking to other markets there is technology today where you have advances in the listed derivatives marketplace, for example, where you have -- where the SEF or the execution broker in that context has real time connectivity to the FCM, such that when that customer comes in to trade, either on an opening morning basis on a clip size or total no show for the day, duration adjusts, for example, within the CDS context, that that counterparty, that there's sanctity in that trade, that both parties know that that trade is going to clear. And you can do that today by bringing in this greater than tangential but direct relationship between the FCM and the SEF for that connectivity. I think over time you can get a real time connectivity such that in the few milliseconds that it takes to buy
or to lift an offer off a screen you've already 
queried the staff to say yes, no, does customer A 
have the ability to pay for that 100 million IG 15 
trade.

MR. RADHAKRISHNAN: I think we're going 
to take a short break, a 15 minute break.

Unfortunately, there's just one restroom. One for 
men, one for women. But if you took the escalator 
downstairs, if you walked out and took a left 
turn, I think there may be another bathroom over 
there. So 10:45, please. Thank you.

(Recess)

MR. RADHAKRISHNAN: Can we take our 
seats please? All right. We're going to carry on 
our discussion and I'd like to make sure that the 
momentum that was built in the first session 
carries on.

So my colleague Steve Greska has been 
chomping at the bit to ask a question, so I'm 
going to let him ask a question.

MR. GRESKA: I was hoping I could keep 
the momentum going. When we first started this
morning and talked about the 95 percent commitment by the dealers, and I know there's correspondence and I've been to a couple of other dealers and they've mentioned that they fulfilled this 95 percent commitment, they've already fulfilled it or they continue to fulfill it. And when you look at the public information at the Trade Information Warehouse and you see the gross and that notional and the indexes and then you see the notional value of what's actually being cleared, I was wondering what exactly is the commitment specific?

What is the commitment and how is it being met?

MR. DIPLAS: Okay, so let me clarify because unfortunately there are a couple of 95 percents that actually coincide. They're not the same 95 percents.

So first starting with the commitment. The commitment that the G-14 dealers and several large buy side firms have made to the global supervisors group was to submit 95 percent of new trades for clearing. Okay? And afterwards -- so this is what we can do individually. Submit the
trades for clearing. Obviously, there has to be
an eligible counterpart actually on the other side
of the trade. And then there was a collective
commitment for what actually is going to be
cleared. And we started at 75 percent and then we
went to 80 percent.

SPEAKER: Yeah, I think that's right.

MR. DIPLAS: We went to 80 percent.

Okay? So that was what has to be cleared
cumulatively, 80 percent of looking at certain
index. Okay? If you look at what we have
actually done, we have managed to clear
cumulatively or compress, which is the same thing,
more than 95 percent of those indices. Okay? So
we have exceeded that 80 percent commit to clear
and we have cleared more than 95 percent of those.

Just to explain also when you look at the --

MR. BENISON: No, I was just going to
say maybe go through the compression point.

MR. DIPLAS: Yeah, exactly. No, that's
what I was getting to.

When you look at the numbers currently
in the warehouse, it's very difficult to actually look at them and just get a good idea as to how much has already been cleared. The reason for that is that there's an inherent compression that takes place that it's out of clearing. We look at on average something like a nine to one compression, and I'll tell you why I use that number because it's a very convenient number. So let's say we start with 11 trillion of an instrument. Okay? For argument sake we submit 90 percent -- we clear 90 percent of those. So one trillion stays out and 10 trillion are submitted for clearing and gets cleared. Out of that it gets compressed down to something like one trillion. So if you look now what has cleared versus what has not cleared you will see 1.1 trillion on one side and one trillion on the other side. So it will look like as if the market now, 50 percent of it is in the cleared stage, 50 percent is not, but the reality is you have actually cleared 90 percent of what was available to be cleared. Okay?
So I know the numbers get a little bit confusing in that respect but, so collectively among eligible counterparties, yes, in all these indexes that we started, you have cumulatively cleared or compressed more than 95 percent of them. And the numbers vary and you will see kind of a drop in these numbers obviously every time we issue a new index. Obviously, it's a new instrument again. We have to restart clearing it. Also, you can see the numbers drop for a short period if we are the new clearing member because more trades become available to be cleared.

MR. GRESKA: And that's going all the way back to like say Series 9 and the investment grade when we see --

MR. DIPLAS: Yes.

MR. GRESKA: That notional, that 1.5 trillion notional?

MR. DIPLAS: Yes, Series 9 is one of the few indices. Actually, all the indices are kind of trades. It just happened to have a lot of names that were relevant and a lot of existing
trades. That's why it maintained some liquidity but obviously you can see a lot of the others. Some of the indices before don't have the same activity obviously.

MR. BENISON: And you see that, no, I was just going to say you can see some of the impact of this if you look at the notional outstanding in the warehouse. Right? And it used to be a much -- the peak was 60, 65 or something. And that shot down. Now, today it's 25. And much of that, some of that, a little bit of that is rolling off but a lot of that was just due to compression that took place either through direct tear ups or through the clearing.

MR. RAMSAY: If I could follow up on a point before the break that was being made, people were talking about the processing of these instruments upon a credit event and the benefits, clearing benefits of having that done in an orderly way. And based on a, you know, an understood set of criteria, would that suggest therefore that for a particular product the
greatest market benefits come about if that product is traded through a single clearinghouse as opposed to multiple clearinghouses where there might be different sorts of criteria applied or it might not be so well understood? And do people think that that would tend to happen as a, just as a natural migration from the market demand would all go to a single place? Could there be a single product traded through more than one house and would that pose complications?

MS. TAYLOR: I think what it points out is that clearinghouses need to be in a position to create certain elements of their services in ways that don't create a basis risk between the current market conventions and the way that the cleared transactions work. So I don't think it calls for a particular product to be cleared in a single clearinghouse but I do think it calls for the credit event processes, for example, to be consistent to a large extent across different venues so that there is not basis risk created.

MR. BODSON: I would think that that's
the role we play, the Trade Information Warehouse plays is in the post trade events, credit events or what. By having it done one place there's a no gap risk, there's no differences in how it's going to be handled. It's all done uniformly. So those types of issues disappear because we are able to aggregate all the positions. So there's two benefits in essence in terms of what the Trade Information Warehouse does. One is the reporting benefit of having one aggregated view and the other one is the standardized processing of the asset servicing side of the life. And that's the role we play in the position we do. So it allows a proliferation, if you wish, or you want to have the competition at the CCP level, it permits that the hand happen without the operational risk of downstream processing happening after the fact or the gap or the arbitrage, whatever that could happen if you have different processing occurring. So that's the true benefit in the stability and the foundation.

We've handled 48 credit events, I
believe. When I was at Morgan Stanley the first credit -- I'm trying to remember. It was a small Canadian tree company. I forgot what it was. I think it took about four weeks to process the event and there was complete panic. And everybody said, God, thank God it wasn't General Motors. General Motors was a two-day event.

MR. MOONEY: If I could --

MR. RAMSAY: Go ahead.

MR. MOONEY: If I could just ask a quick follow up. Can I get your thoughts on sort of interoperability among CCPs and among market infrastructures?

MS. TAYLOR: I think interoperability is a question that gets a lot of play. I think that there possibly are places where it is -- I think it depends on how you define it and depending on how you define it there probably are places where it is relevant. I think it is important for, for example, CCPs to be able to interact with the Trade Information Warehouse. I do think that one of the things that I have failed to point out so
far during that part of the discussion is that
different clearing services are structured in
different ways so they actually need to interact
somewhat differently with the warehouse. The
question that you were raising, Steve, about the
difference between the open position shown in the
warehouse and the open position shown in clearing,
in the case of our clearing service for credit,
the trades no longer exist in the warehouse once
they have been cleared. And so the relevant piece
of information to be put into the warehouse as a
result of our clearing service for credit would be
the net position that you have left. And so there
wouldn't be a difference between the kind of
cleared open exposure and the warehouse open
exposure if people are reporting it based on the
net open position.

So I think that there are some cases
where entities need to be able to interconnect. I
think interoperability as a matter between
clearinghouses is something that is more complex.

That brings with it credit risk between CCPs and
interdependence on the risk management regimes of different CCPs where there can be differences in the way that services are constructed. There can be differences in the way that margins are calculated. There can be differences in the balance between margins and the guaranty fund process. And done inappropriately the interoperability between CCPs can actually create more systemic risk rather than helping to reduce systemic risk which is really the goal of the clearing service.

MR. HARRINGTON: From a client experience standpoint, one thing that we've seen, especially in CS working with both -- with Kim and Chris at CME and ICE for our end-users is the functionality in the clearing systems and, you know, all of the, you know, margin requirements that the CCPs mandate, that's obviously their business and they obviously compete in that space. But from a -- from the actual ability to reach the clearing destination I think the interoperability is very good, mainly in the fact that, you know,
when a client decides they want to clear at CME or ICE, we're able to give them direct access to both clearinghouses. They're able to see, you know, in an almost real-time format, you know, the status of their trade from execution to DCM acceptance to the ultimate clearing of the trade happen. And the actual experience is very much the same. So obviously there's going to be competition on the merits and that's a good thing, but I think that the final result is a very fair and very good outcome.

MR. EDMONDS: I would agree with the comments that Kim made on the complexity of if you're talking about CCP to CCP interoperability. I mean, fundamentally, before we even get into the technical merits of that, and I'm not sure that this is the place to do that, but philosophically, I mean, Dodd-Frank was very clear that we should move as many of these OTC products into a world that we had become accustomed to and the safety and soundness of -- we'll call it the FCM futures model, whatever you want to -- it's not exactly --
one size clearing isn't going to fit all. And we talked a little bit in the earlier morning session around some of the challenges around that.

But before we even get there we're going to start having an experiment in top down market design. It seems incredibly dangerous. I mean, legislation asks us to go one place. We're now mandated to go there. The regulator's job is to provide us some rules of the road of how to get there. And before we get there we're going to think about going in other directions and expanding the scope of that. And from my perspective I think it's an incredibly dangerous track to go down.

MR. DIPLAS: I think that, I'm sorry, I think that at the current state of clearing the probability is not feasible to the extent that -- I'm talking about derivatives interoperability. I'm not talking about cash. I think that can be done in cash.

On the CDS side, right now to the extent that we have CCPs that have different membership
requirements, different risk frameworks, sometimes
even different actually underlying instrument, it
is very difficult to think -- and when I'm talking
about interoperability, I'm talking about the full
interoperability that says Tom and I trade, he
decides to go to CME, I decide to go to ICE. That
is like playing a football game. He goes to
stadium A and I go to stadium B right now. We
cannot meet. So it doesn't work at this stage of
clearing.

In the future, perhaps if we can do
that, that's fine. But I would agree with Chris
that I think our number one priority is actually
first get the trades into clearing, get some
confidence that actually we can do this correctly,
and then we can worry about whether we can
actually achieve the interoperability or not.

MR. PIRRONG: Yeah, from an economist's
perspective, I mean, there are tremendous
economies in scale and scope in this business,
whether it's due to netting, diversification
effects, and so on. So I think that there is
going to be a tendency from migration to a single clearinghouse or a small number of clearinghouses. How that migration takes place will in part depend on if there is mandated interlinkage between them. But the one caution that I would make is that, you know, we sort of had mandated interlinkage in the equity market for example and we saw that under times of stress, like on May 6th, that's when those linkages break down. Well, the whole point about clearing is to basically deal with those stress situations. So I think you have to tread very carefully with looking at interoperability and particularly mandated interoperability in clearing.

MR. RADHAKRISHNAN: Let me ask a question about competition. I think while there may be very healthy aspects of competition, it's also possible that there may be unhealthy aspects of competition, specifically CCPs competing on margin in a race to the bottom. So what suggestions do people have for the regulators to make sure that this doesn't happen? Should we,
for example, I'm not suggesting it but should the regulators mandate a particular margining methodology that all CCPs have to use for credit.

MS. JOHNSON: Could I hope in there?

Ananda, if I may, I'm sorry. I think this question is tremendously well linked to Kim's comment earlier about systemic risk. And to the earlier comments in the morning session about a race to the bottom. In an earlier comment I noted that, you know, each of the CCPs is an independent business competing on its own merits and developing its own proprietary practice models and practices for risk management. If there -- whether it's clear that Dodd-Frank mandates clearing of all or how we define all eligible CDSs or requires the bringing in of as many things as possible, I think one point not to miss and that is more obvious than all of those is that the systemic risk that arises from some negative aspects of competition, the negative externalities that can arise in the business should not be overlooked. And there's a place where I think
there is a tremendous opportunity for the regulators to act innovatively in that while it is the case that each CCP is its own business and will develop its own models and practices, there has to be for normative reasons a threshold beneath which no competitor is allowed to sink. And the purposes there are to ensure that all the benefits of the multilateral netting are captured without bringing into the picture the negative externalities that will certainly arise from not -- ineffective pricing or risk management practices.

MR. BENISON: So, if I can, I think there's a couple of things to think about. I don't think it makes sense to say we're going to mandate that you all use the same margining process. I think if you do that you potentially lose the benefits of innovation, you lose the benefits of having different people looking at the same problem and coming up with a different answer. And there may be different reasons why one CCP decides to margin differently from
another.

One of the questions that also comes into that is not just margining but how do I break between the IM and the guaranty fund? And how do I break between what's funded in the guarantee fund and what assessments rights are and how much that is? So I think it's more important to ensure that there's transparency as to what standards each CCP is using; that there's enough enforcement to ensure that CCPs are in fact meeting the standards that they have set for themselves; and three, ensuring that to the extent you've got reliance upon assessment rights that you can reasonably expect that your nondefaulting members will have the liquidity to pay those assessments, you know, in a timely fashion when you have the default of another member.

MR. RAMSAY: I was going to ask a related question which is obviously there has to be some ability on -- presumably there has to be some ability on the part of clearinghouses to innovate, play their own methodology. What
happens in a situation where, you know, leaving
aside questions about valuation, if you had very
similar products traded on more than one
clearinghouse, in the event that just the amount
of margin collected is significantly different in
one case than the other, what would that say? If
anything, what would it say from a regulator
perspective? Would it suggest that -- should that
raise questions? Alarm bells? Should one assume
that if people are, you know, following good
prudent risk management purposes that those ought
to be fairly similar?

MR. TURBEVILLE: That has happened. And
I think one exercise that might be helpful is to
go back and look at times when that's occurred in
various products and to try to determine what's
going on. I think the motivations now might be
different from where they were prior to 2008, but
there's no doubt that competition among
clearinghouses, it's a relatively new phenomenon.
And there's no question that one issue, one cost
factor is margin and one cost factor is
correlations. It's a deep question that is worth thinking about. But I think one thing we know now is that the level of activism to understand what's going on by the regulators and the level of expertise in understanding how those numbers work, there's a need for a greater focus on that, especially as clearing becomes such a central feature in the financial system.

MR. GOOCH: I think one thing to think about is you do get those anomalies from time to time. And I think, you know, we talk a little about competition and multiple clearinghouses clearing the same product. But I think we need to be very careful we do have genuine competition. If you think about CCP, they're trying to set margin levels. And how do they go and commercially win the next trade to be cleared? And how do they risk manage the existing trades?

The next trade for the individual user is more driven by correlation, the impact on the default fund contribution, a lot of factors other than just the margin go into that decision to put
a trade into an existing clearinghouse. I think if you want to have competition on margin that was more generally, interoperability probably isn't practical. I think we've been struggling in the cash markets to make it work. Maybe in 10 years time we can also come back here again and have a debate about OTC interoperability but we're probably not going to get there at the moment. But giving people the ability to move trades between clearinghouses I think is quite important. If you pick a clearinghouse today, if you leave that trade for two years, if you and your counterpart agree, you might want to move those positions. You should be able to do that and that would I think in itself create enough competition to iron out some but not all of these anomalies on margin. Otherwise, in practice it's going to -- market pressure to fix some of these things.

MS. MARTIN: To talk --

MS. TAYLOR: Oh, go ahead.

MS. MARTIN: Just to touch on a couple of points. I agree with a lot of what my
co-panelists have said. But to go back to
something Mike said earlier in the earlier session
this morning, it comes down to the analysis
process that you force a DCO applicant to undergo
while they're going through the application
process. And the in-depth of that analysis
process is very similar to what you have been
undergoing with your portfolio clearing. But in
our view it's not just a process that ends when a
DCO gains its license. It's a process. It's a
continuing process that -- where the DCO should
have to review its risk management capabilities,
its risk management functionality with the
different regulatory agencies throughout the
lifecycle of its clearing.

MS. TAYLOR: With respect to kind of
answering your question about whether there could
be legitimate reasons why margins would be
different at two different clearinghouses looking
at the same product without something being wrong
with that, I would just offer a couple of points
of consideration. One is that there are some kind
of basic statistical tests that clearinghouses undergo in evaluating margining, and there are basic coverage standards. Tom talked about this a little bit. Standards that the clearinghouses set for themselves to be able to cover. I think one thing that would be important from the regulatory point of view is to be able to monitor whether clearinghouses are actually adhering to the standards that they've set for themselves.

But I think it is not unreasonable for clearinghouses to set somewhat different standards for different products for the same product set given different environments that they might be operating in. They might be operating in a situation where they have more clearing members contributing to the pricing and the default management, therefore, the liquidity that they would face would be better than the liquidity another clearinghouse might face. That's one example. They might be sitting on a book of positions that is very diversified across and kind of evenly spread among market participants, a
large number of market participants, or another clearinghouse might be sitting on a book of exposure that is more concentrated that would affect the level to which they do margining.

They also could be making a slightly different choice about the mix of resources that they want to bring to bear in a situation of a default. The waterfall could be leaning more toward margin, could be leaning more towards the guaranty fund, and both of those are very legitimate choices as long as the ultimate outcome is that the clearinghouse provides for the ability to withstand the default of the x-number of market participants that is determined to be the target there. So I think there is definitely room for legitimately different decisions to be taken in looking at the margining for the same product.

MR. BODSON: I think --

MR. DIPLAS: I would agree.

MR. BODSON: Sorry, the CPS IOSCA standards for clearinghouses, settlement systems, or payment systems are out there that everybody
should be subject to. You know, the point, if there are differences the question should be, of course you should question it. And there could be very legitimate reasons or there could be very, you know, not so legitimate reasons. But that's the role of the regulators. But it's also the role of the market participants. There are offerings out there where people have said I'm not going to go near those guys because it's way too much risk. It's not always about, believe it or not, Wall Street is not always about money and trying to find the cheapest trade to do or, you know, maximize the profit. We do, as I said before, we do want to survive. And if somebody is going to take -- have you come in into a risky situation everybody will pass. When we started Euro CCP, the one thing we heard all the time, we have very high membership requirements, this is our European KAS CCP, was you're charging me -- your requirements are way too high on me but make sure you get that guy because he's really weak. Okay? We all love each other except when it comes
to trusting each other.

MR. DIPLAS: I agree with Kim's comments in terms of that the CCPs can have some flexibility. And I agree that the books might look different and they should have that flexibility. The regulars have to make sure that fundamental assumptions though are consistent. I think to me that's the most important element. Having one CCP assume that they can actually withstand one significant member default, have another sustain three members default is not a good situation. I mean, people vote obviously sometimes with their wallet, sometimes they vote for risk reasons like I said, and obviously we're going to make these decisions. And sometimes clearing members might not have the full picture and the regulars have that full picture. The underlying framework assumptions that Tom alluded to, assessment rights. Is the CCP there? Does it have -- if you put a dollar in the guaranty fund, are you assessed a second dollar and then it is game over? Are you assessed multiple dollars?
That is a fundamental assumption. And that is what's going to have the most systemic risk impact than anything else. Some of the small stuff, micromanaging the margin whether it's 1.9 or 2 percent, I think we can live with that.

MR. RAMSAY: But even in terms of the general standards there may be some play there. I mean, there's the international standards Mike was mentioning, you know, in the views of some are probably too lenient. There should be, you know, stricter than being able to handle the defaultable largest one. So it's -- it will be a struggle from the regulatory standpoint to figure out where the baseline is.

MR. RADHAKRISHNAN: Let me ask a question about the specific risks of CDS. There is this notion of a jump to default and there's also a notion of a jump from default. So the question is currently the clearinghouses that offer clearing procedures, what additional considerations have you put into your risk management systems to take into account the
specific risks of CDS? And once you hear from the CCPs, the others will point to other things that people should think about.

I don't mean to put people on the spot but I am going to put people on the spot.

(Laughter)

MR. IVANOV: Indeed, fundamentally the risk of the CDS instruments is quite unique and is quite skewed towards protection sellers mainly from jump to default. So ICE specifically will look at many different types of risks associated with CDS products. The first one is the so-called spread dynamics, namely how the spreads are moving upon extreme conditions without even entering an explicit state of default. That would be the first factor.

The second one would be liquidity risk, you know, liquidity requirements that should be assigned for different instruments. Definitely, as we discussed in the previous session, different instruments. They have different market activity, different liquidity upon extreme conditions
definitely the bid offer could substantially widen. As a result we have models and we have ways to estimate the liquidity charges associated with liquidating big portfolios because we have to all remember that the current settlement levels, they correspond to eventual mid-level that should be very accurate. And it's used as a base point, reference point, for looking at the margin requirements and how they perform.

The next type of risk that we'll look at is concentration charges. We have very specifically designed concentration charges that approach the maximum liability as the positions increase. For example, from a protection seller point of view the overall margin requirement could approach the total notional on which protection has been sold. And if you're a protection buyer, then the requirement could be the full coupon payment, the forward payments. Of course, we mentioned the jump to default. We have specific sensitivity analysis associated with assumptions about the recovery rates. Typically, we'll look
at jump to default in terms of minimum recovery rate, which is name specific, sector specific to reflect the overall risk of these instruments. We look at interest rate sensitivity in terms of what would happen if the spread market performs in the same way but there is all of a sudden significant move of the default-free interest rate.

So the final requirement is a combination of five different risk elements and we attempt to quantify very carefully each of these elements and build the total margin requirement, which would reflect all types of — or practically five different elements of risk associated with those instruments.

MS. TAYLOR: We have a not dissimilar approach theoretically. We have a seven factor model that looks at a variety of different sets of market conditions. In many of those factors the margins automatically scale as the spread on the product increases. But then there are also specific liquidity considerations and specific jump to default. One of the factors is a jump to
default or jump to worse credit type of
evaluation. And then there's also an element in
our minimum margin that considers the margin that
is calculated based on looking at the portfolio
and all of the different factors as well as
looking at the jump to default risk. And then
that could trigger a minimum.

MR. GRAULICH: So we have also developed
a model which funnels the specifics of credit
default swap. And in particular, the asymmetric
risk profile of the protection seller and the
protection buyer. So, for example, the protection
seller has to post a special margin which we call
a credit event margin which is oriented or
calculated based on the largest exposure within a
portfolio with regards to individual names. So we
assume that if the biggest name in the portfolio
defaults, then we assume a recovery rate of zero
and the second name with a recovery rate of 40.
So that reflects the credit event element and on
the other hand the protection seller, of course,
has the risk or carries the risk of the crude
premium margin. So it is also separately margined. So to characterize or reflect the characteristics of this asymmetric risk profile between protection seller and protection buyer is reflected in our margining methodology.

MR. CURLEY: Can I just ask? Maybe just to provide some context for those three descriptions, can you give a sense of how your models have changed over a period of time? What have you learned from the process of introducing the clearing of these products? And what areas are you still thinking about, either in comparison to the, you know, other platforms in your own modeling that are issues you expect to face in the near future?

MR. GRAULICH: I think, if I may continue, I think the margin methodology is only the way to make sure that in a default scenario you have sufficient margin. What is ultimately important is that this model is strong against stress testing. So if you do stress testing, testing your margin methodology against what can
1 happen, and that is from my perspective the
2 ultimate way to make sure that there is a
3 consistent methodology or consistent approach to a
4 wide race to bottom on the margining side between
5 clearinghouses that all clearinghouses have to
6 ensure that, for example, they are compliant with
7 a 99 percent -- 99.9 percent confidence level with
8 their margin requirement and their clearing fund.
9 And I think what the regulator could do
10 is to define those stress tests with some more
11 detail to avoid this race to the bottom because
12 there are many assumptions in those stress tests
13 which ultimately make you comply or not comply
14 with regards to the margin requirement. I think
15 the margin -- the margin methodology itself should
16 stay with the clearinghouse because the more
17 sophisticated you are on the methodology side, the
18 more you are aligning yourself with the curve of
19 the stress test which then is efficient or brings
20 efficiency to the market. So I think the
21 regulatory side should focus on the stress testing
22 of the portfolios or the margin methodology.
MR. IVANOV: Yeah. I would completely agree with Matthias that the main thing is there should be some flexibility in terms of how the guaranty fund and the margin requirements are set, but the ultimate test should be what is the stress test scenario or set of scenarios that we want to be protected against and extending the discussion I would say that for example, at ICE we look at two simultaneous defaults of the two biggest losers upon extreme conditions and then assuming the three single names in those portfolios in which they wrote protection would be defaulting at the same time. So overall, the stress test scenario used to determine the size of the guaranty fund would correspond up to eight simultaneous defaults which is a very extreme type of realization along with additional widening and tightening.

In terms of definite skew of the risk profile, the margin requirements at ICE, for example, they're about three to one, even more skewed toward protection sellers which are the
main sources of systemic risk. In terms of evolution of the systems and the models, the main thing that we're focused on currently is how we account for basis risk and how we provide a single name versus index benefits in an efficient way without making it prohibitively expensive to maintain a flat risk profile. Because on the other hand, if we don't have the proper portfolio margining, then it disincentivizes the clearing participants and overall clients of the clearinghouse to maintain a flat risk profile which would be the ultimate goal because the clearinghouse when deals with less actively traded instruments, would be able to more easily unwind such portfolios upon auction.

MR. RAMSAY: At the risk of getting a little heavily into the weeds on this, and if there's a lot of stress being put on stress testing as something that can provide comfort, is it presumably the meaning of extreme and conditions could be different -- viewed differently across different firms. How much from
a regulatory perspective can practically or should
the regulators try to make sure that those things
are defined similarly, I mean, in term of it can
be different depending on sort of the historical
horizon you're looking at, the number of kinds of
factors you're looking at, the number of factors.
How should we look at that from a regulatory
standpoint if anyone wants to?

MR. EDMONDS: I mean, I think in some
respects there are examples of previous behavior
where that stance has already been taken where,
you know, either through launches of new products
or the certification products of new products and
things of that nature where regulators, CFTC
specifically and SEC as well, you know, have asked
how certain assumptions being made around the
management of these instruments would have behaved
during historical points of reference, be it
Lehman or some other high-water mark that's out
there that we want to make sure that's cared for.

So, you know, I would offer that you're
on the right trail with that. You've got to get
to a level of comfort that you're asking the right
questions around that but, I mean, those are the
only, I mean, can we solve things that we don't
know? I mean, we're going to use a historical
reference point to get there and say we're better
than it was before. We've learned, we've made
improvements, the process has given us now a
better market in which to operate. So I don't
know how else you would get to that point. Now,
it would be up to you to make a determination as
the regulator whether or not the answer you got
was sufficient but, you know, certainly those are
the questions.

MR. DIPLAS: I could give you a couple
of things that we haven't experienced yet but I
think it's something that you might want to
consider going forward. For one, I think it's
clear that if you compare CDS versus other asset
classes, it clearly requires a longer unwind
horizon. So talking you might need a few hours of
the day for Euro dollar futures but you need
probably a week or two for CDS. And depending
again what we're looking at that.

The second thing that is actually unique, we haven't done that yet, is correlating sequential default, which is especially as we get into client clearing, I think you're going to have to worry about a situation that a large client default, the FCM, and again it goes back to membership requirements on the staff is unable to handle that client default. And if it defaults itself, that actually increases the CDS trading, increases the values for everybody else. And then you have to worry about how to do the unwind.

Okay? That is something again that we haven't experienced but this has to be on the radar.

And then lastly, there has to be consistency in terms of decision-making. It goes back to what we mentioned earlier about the determination committee. There are events that have to be --

MR. RADHAKRISHNAN: So Athanassios, you're saying both the client and the firm are names?
MR. DIPLAS: Well, that is -- yes.

MR. RADHAKRISHNAN: Okay.

MR. DIPLAS: Well, one or the other. I mean, that would be a scenario but obviously, I mean, I'm giving you the worst case scenario. Right? I mean, but either way you have to worry about the client -- first of all, the FCM being able to handle the portfolio because if they don't, then they default and then we have to basically figure out what to do with their portfolio.

And the last thing, the determination committee consistency. You need to ensure first of all that, you know, when we say -- in general, we tend -- most market participants, at least the clearing members which we care about in terms of managing their default, they tend to run pretty small net books but very large gross books. So you want to ensure that there's consistency obviously in terms of the treatment of these trades and you don't want to have a situation that CCPA says GM defaulted; the CCPB says it didn't
default. Okay? In that scenario, right now the current CCPs obviously are aligned in that respect but you want to ensure that if a new one comes up they don't have the option to say I won't listen to what the determination committee says; I'll do my own thing. Because also remember as the default happens, clients will be moving positions from FCMA to FCMB or potentially from CCPA to CCPB. And you need to ensure that those things are going to move smoothly. So these are things that have to be on the radar and again, as I said, the new things, we haven't dealt with them before but we have to think about them.

MR. RAMSA: And how as a practical matter does one do that from a regulatory perspective? I mean, is it enough to sort of make sure that the sort of machinery or the type of process that's in place in terms of determination committees and making those decisions is roughly the same across clearing agencies?

MR. DIPLAS: Well, the next committee one would be easy. There would have to be a
commitment, absolute commitment from the CCPs. They will abide by these decisions like any other member of the trade. It is written in the rules and it is written in the contract. And then there is actually no optionality. That makes life easier. Some of the other stuff I described actually is much more complex. At least that one is the easy one. We can say -- we can rule that that is the case.

MR. BENISON: So just to be clear on that, so the ISDA determinations committee, under the contracts, you know, as part of the changes, you know, CDSs have been standardized, I keep saying this, for 10 years. We've made some changes to those standards. One of those changes was to move to -- move from bilateral agreement as to things like successor events and credit events to the ISDA DC as the place to make those determinations. So there's a determinations committee with representation for the buy side, sell side, that turns over over time where the decision is made. And so I think what Athanassios
is talking about is having that determination committee be recognized as opposed to separate determination committees that might all reasonably look at the same situation and potentially come to a different answer.

MR. RAMSAY: So that would presuppose -- I'm not suggesting it's inappropriate -- presuppose this regulatory matter that we're in essence looking to a private sector sort of organization for making those determinations suggesting a clearinghouse. It should reference those in each case.

MR. BENISON: Yeah, I think so. But I mean, if each clearinghouse has its own those are private sectors at this point anyway.

MR. RAMSAY: Right.

MR. DIPLAS: Plus, we have gone now through about, whatever, six or seven credit events and that has actually -- one thing we can say about the crisis, one thing that worked well, that was it.

MS. JOHNSON: But there are real sort of
legal concerns with looking to ISDA as the determining body for these issues. While I think there are obviously economic efficiencies in certain operational benefits for having the determinations committee of ISDA make the decisions for the industry and so that there are not sort of competing interpretations of what's happening, for the regulators the reliance on ISDA is politically less easy or even legally less facile in part because ISDA is an independent non-governmental agency that doesn't have immediate accountability to a federal agency or a particular standing under any sort of specific jurisdictional rules. And the mini jurisdictions where ISDA's sort of policies certainly sort of direct the market. So there is sort of a gap there in taking that step that is something for the agencies to look at very carefully.

MS. JOSEPHSON: Picking up on that point, we've been focusing on the product documentation to some extent and the determinations committee around credit events, but
I was wanting to solicit the group's views on the relationships between the clearinghouses members and customers in terms of documentation. The sort of master agreements but also client arrangements, give up arrangements, and ideas about how those documentation issues could be addressed with the overarching concern about access to clearinghouses for customers, the client clearing initiatives that have been underway.

MR. CAWLEY: Let me jump in. I think a good place to start when you look at clear product is to look at where the other cleared product is in the listed derivative space. So, you know, there is precedent for clearing agreements and for, you know, give up agreements that various bodies have put together, you know, from the list of derivatives experience and they're pretty good. And they're pretty simple. They're pretty symmetrical. You know, one of the things that we're looking at is the current execution, give up agreements that are in place there to draw -- to draw that experience from.
We should be mindful that the agreements shouldn't be overly complex and should just really deal with the facts and the issues themselves. Standard clearing agreements, again, it's a good place to draw from is from the list of derivative space.

MR. EDMONDS: I would add that, you know, prior to the legislation, right, the world was much more gray. And it leads to the documentation that we employed at ICE Trust was one, to remove that gray area. And we did that in terms of a standard terms annex. Now that we have legislation and with the implementation of the rules of that legislation, and there will be opportunities for us to move with much more legal certainty than existed prior, to a more standardized documentation that is consistent with the FCM or agency-based model that in our opinion, based on the regulatory construction which we operate, were not available to us. And introduced more confusion than it was worth at that point in time.
Certainly, those standard agreements that Jamie makes reference to in that they've been negotiated between clearing members and their customers for their entire existence and they've become form like in some respects and they've moved along to serve a very specified purpose. There is still a bilateral nature in those agreements of what the clearing member and the risk around the clearing member is willing to accept on behalf of those individuals. That's not necessarily a CCP issue. Our issue is to make certain that our rules govern the product and the behavior of the participant in a consistent manner. And we're certainly moving the transition to that new documentation that's now for the first time available to us under this.

MR. GOOCH: I think --

MS. TAYLOR: We brought our service to market under the FCM model originally and so the documentation process I think was much simpler than the documentation process that needed to be followed in some of the other cases. There was an
annex to the futures agreement. I would expect
that that's going to be the way that things will
move forward under the new legislation and
regulation.

I would like to say one thing about the
give up agreement though. I think there
definitely is a time and place for there to be a
complete industry standard around certain things.
I would say the determinations committee is a good
example of that where you don't want necessarily
different outcomes from the same set of facts
about whether there's a credit event or not. But
with respect to things like the give up agreement,
I think that there is -- I think there's a
tendency by the industry that has long been a ISDA
governed consensus based process that they don't
do anything differently unless everybody agrees.
And the -- in the case of the give up processing,
it is an operational process. It's a credit
process. It's a part of the service that is an
example of something that could be innovated on by
one or more CCPs in slightly different ways to
provide an efficiency to the market participants. And having a process that says that type of thing has to be governed by an agreement that everybody has to agree to before anybody can innovate is probably going to stifle the ability of the marketplace to respond to changes in market conditions and provide innovative services.

MR. BENISON: One thing I would say, and I don't think we have much in the way of end-user representation here, but I think, you know, from an end-user perspective as we've gone through and from all the dealers at Southside, we've all negotiations bilaterally with clients, working with multiple clearinghouses in working groups with end-users and what these agreements should look like, and I think one of the things we found out is that as clients are going over the detail of the existing futures agreements, they're starting to see things where they say, well, you know what, I don't really like that. I kind of want to change that. I want to change the way that works. And I think, you know, as a whole, as
we've gone back and said, look, we need to take derivatives -- derivatives are a 15, 20 year old product. We need to modernize them. We need to make them safer so we're going to put them into clearing.

We also need to look at clearing and realize that clearing hasn't changed that much in a longer period than derivatives have been around. And so from the perspective of the OTC swaps market, people are very used to be very documentation intensive and going through and looking at all this. And as people went through and started looking at clearing, we found that we've had to make a lot of changes and a lot of those we've worked with the clearinghouses on and elsewhere. And so that's still ongoing. And from an end-user perspective they're still looking at those issues as well. So I think it's important to remember that, you know, we need to move the documentation along but we need to take into account all of the relationships and ensuring that as we move swaps, you know, we take swaps which
havn't been in clearing and we put them into clearing that was originally developed for products that are very different that we're sure we make the changes that are appropriate for that.

MR. RADHAKRISHNAN: Could a possible solution be for the regulatory agencies to prescribe documentation if there is no consensus and if you assume that you want to get to, you know, a state of affairs which is clearing by a particular time. And if you leave it up to the market participants and nothing happens, should we prescribe something?

MR. EDMONDS: But to Kim's point that she made a little bit earlier, I mean, part of the function in that documentation relates to a number of different bits and pieces between the relationship, credit being one of them, that's being extended by the clearing member to the end user. So while you might be able, as a regulatory authority to assign certain minimums that documentation must include, being overly prescriptive of that, I'm not sure you're ready to
wear that risk.

MR. DIPLAS: I think the industry is already incentivized to actually get this done quickly, both by certain cell side. And I think again we're all incentivized to ensure that we define the most -- the common things that we can put in a document that they can apply to everyone because that makes for a simple document. And obviously to the extent we still manage a bilateral relation, we still need to maintain that flexibility to manage that. So I think that is something people are spending a lot of time both -- and also with trade associations to actually get that done. So I agree with Kim's comments obviously that, you know, sometimes we take too long. It's like herding cats. But we'll kind of get there.

MR. RADHAKRISHNAN: Speaking of incentives and disincentives, both the SEC and the CFTC have the responsibility to set margin requirements on those entities that will register with us as dealers and who are not regulated by
the prudential regulators, i.e., the banking regulators. So how should we do this? On the one hand -- (Laughter) I'll come out and ask. It's been on my mind for a long time.

MR. RAMSAY: You each get two minutes.

MR. RADHAKRISHNAN: How should we do this? And the considerations are, one, you want to make sure that there are incentives to clear. Right? Number two, at the same time I guess there would be some products that just cannot be cleared and will remain bilateral. And what is a balance? You don't want to be punitive. So, and I guess the question can be asked on different product classes but specifically with respect to CDS. How should we do this?

MR. DIPLAS: But you are right in saying incentives. First of all, let's look at the current state. We have tremendous incentives to clear. If I face a counterparty bilaterally versus actually having the same trade in the CCP, I get a tremendous benefit in terms of the capital that I have set aside. So that incentive is
there. The part I would sorry sometimes is when people use the word incentives if they say that the risk is X, capital should be 3X instead of X. Because if you do that you don't create -- you creative incentives, yes, on one side but also you will actually create an incentive to put things in the clearinghouse that perhaps shouldn't have gone there. So that is the kind of defined balance that you need to worry about.

And the second thing is I know I think you correctly said that you were going to have to look at those kind of projects actually are not already regulated by prudential regulators. And obviously, you don't want to create some new loophole there as well. So looking at what are the current capital standards that already apply to the rest of us basically that already have to pay those prudential capital requirements is very important. So it's consistency that we care about obviously.

MR. RAMSAY: We've been dancing around.

A lot of the comments here have sort of been
dancing around issues involving the interests of end-users but I'm not sure that we've really kind of addressed that sort of head-on. So I guess maybe I'll sort of ask a general question or maybe preface it by saying that the -- I think perhaps a fair reading of legislative history and the congressional intent could be to suggest that this market, the swaps market in particular, not necessarily CDS market, is overly concentrated in terms of market share, that part of what we ought to be doing through the exercise of the regulatory authority in clearing is to open that up, to make it more competitive, to provide access more readily to a broader class of people, including to end-users.

If that's a fair read, then how should we as regulators go about it and how should clearing agencies provide access to end-users.

I'll start there. Does anybody want to --

MR. CAWLEY: Why don't I jump in? As a representative of the SDMA that represents independent dealers and FCMs, I think you look to
the fact and you look to the core principles of
the act in terms of open access. And I think away
from the core principles of the act in terms of
open access and requirements for transparency and
so forth, you look to the -- you look to the
prudential nature of the risk inherent in any
system that is too focused and too concentrated.
So what role then can more FCMs again properly and
adequately capitalize? What role can they play?

Well, within the FCM, within the
clearinghouse structure they can burden some of
the risk and they can distribute that risk. For
independent dealers to provide additional
liquidity into the system, that can only bring
greater stability in the system, especially in
times of crisis when you need it most. More
people coming in making more markets and more
products is simply better for the system overall.
So, again, what -- you've got to ask yourself
what, from the clearinghouse standpoint, what can
be done to bring in entities who are well
capitalized who serve and who are very active in
the same clearinghouse in other market contexts but are thus far not yet set up in this system. And there are initiatives right now that are going on where that's changing, which is very good. But again, you know, where you have dealer -- the way in which liquidity and market making has evolved in this marketplace over the past two decades since the inception of interest rate swaps and most recently credit default swaps is really on a dealer to client basis governed by an ISDA. And that market structure is going to change because you have a sort of flattened multilateral prospect where not only dealers to dealers trade with each other but also dealers to customers. And indeed, customers trading with customers. So, again, you know, you've got when two parties come together and they do a trade, the byproduct that they throw off on that trade is liquidity. So that should really be encouraged.

MR. DIPLAS: I would slightly question your underlying assumption in terms of how competitive the market is. If you look at this
industry and you compare it with some of the industries actually extremely infrastructure heavy. You have, I think, you look at something like buying cable service, buying a telephone, buying whatever. You don't have 15 dealers obviously competing over one another for fractions sometimes of a basis point. So that's kind of -- but I'll answer the question anyway.

The issues -- there can be open access and there should be free competition. Whoever comes into these frameworks come in with the same rights but also with the same responsibilities. But then the market can compete and I think clients are going to freely go wherever they think someone offers them more liquidity.

In terms of CDS in particular as an asset class, you do have to be cognizant of the fact that it is more capital heavy as an asset class. It is something that is subject to jumps so that the participants who actually are in there will have to be cognizant of themselves that they will be subject to those jumps. And that is what
has basically weighted sometimes participates in
the past. In the good times they get in and in
the bad times they get destroyed. Again, the
market forces take care of that on their own.
It's not for us to prescribe but I don't see that
there are any barriers in this sense. Clearing
doesn't even lower any barriers. Anybody who
complains, they can equally go to the
clearinghouse and then you can trade with whoever
you want. And I think we'll see that.

MR. GOOCH: I think one thing. You
asked the question about how we bring more
end-users into the marketplace. And I think they
have somewhat different issues and maybe some
firms like Jamie's that want to be FCMS that most
end-users you haven't traded derivatives. If you
sit down with them and say why do you only trade
futures and not derivatives, the main thing
they're worried about is uncertainty. They look
at the OTC asset class and they get nervous about
a bunch of things. They get nervous about legal
certainty of the trades. They get nervous about
the documentation. They get nervous about the
marking. A whole bunch of things. And that
discourages a lot of people from trading
derivatives.

And if we can encourage more of those
people into the market, that's probably a good
thing because they have economic risks they need
to cover and there's more people in the market,
there's more liquidity. It means there will be
room for more dealers to cover the infrastructure
costs and assets we're talking about. And I think
that's the fix to the problem, is just to make the
marketplace bigger. And you need to, I think,
spend more time with the pension funds, the
traditional money managers, the people who have
lots of economic assets but choose not to use OTC
derivatives to hedge them. Most hedge funds do,
so that's not really the issue.

Those guys are looking for your
certainty in the course of the trade and they get
very nervous about, you know, I do a trade that is
enforceful or not enforceful until it gets to the
clearinghouse. They all have different views of what the answer should be but what they're looking for I think out of this process is a lot of certainty about every step in the trade. Some of them love ISDA documents; some of them hate ISDA documents with a passion. You know, I don't think there's anyone that you ought to tell them what they should and shouldn't like in terms of documentation but I do think at the end of this process they want a world where they understand the risks they take, they understand what happens if there's a credit event on the trade. They don't have to worry about those things.

I think that will encourage more people in. And the minute it just looks expensive from an infrastructure perspective and creates doubt in their mind about what they're doing. And I think we can solve that through this process. More people will come in, the market will grow, you'll naturally get more dealers because it'll be more attractive, and that liquidity bridge, liquidity will end up in a much better place. But often we
talk too much about dealers and midsize dealers and clearinghouses and forget the market is actually driven by pension funds, traditional money managers, and others in the credit space actually want to trade the asset class and they have a very different set of needs.

MR. HARRINGTON: One of the things we're seeing from our buy side customers today and this is dramatically ramped up since July and the passage of the Act, the two main tenets of the -- with transparency and then obviously clearing, that in and of itself is bringing back actually two distinct customer groups. Number one, customers who prior to 2008 had been using OTC derivatives either in small or large scale but then also new participants who had never, you know, never been involved in OTC at all who now have a strong interest mainly because of the fact that, you know, the mitigation of counterparty risk is from what we hear probably the primary driver. But then secondly with the, you know, with the tenets of transparency, the fact that
there's going to be so much more data available, you know, whether, you know, depending on the rule making whether it's close to real time, close to end of day, whatever it ends up being, it's going to be dramatically more than what we have today. And that, in and of itself, is going to bring in participants and liquidity into the markets.

MR. TURBEVILLE: My experience with end users, companies that are hedging or mitigating risk and embedded in their businesses because all this is true but the bigger issue is cash. And the biggest uncertainty is having to post margin and watching their businesses go down in flames for lack of cash because they're not banks. They're not pension funds. They're airlines. They're utilities. They're whomever might be hedging the risk. So that the biggest concern with entering into -- of limiting himself to a clearing environment is that they lose access to bilateral transactions in which debt or credit extension is embedded.

So that's the real driving factor in all
of this, which leads to the question whether a system that is bifurcated where you have the clearing system and FCMs extend credit and where you have another system where banks embed credit deals in derivatives is a good system. But that's the system we're in. And that's what we'll -- the less attractive the embedded credit deal is in and bilateral transaction is, the more clearing will occur.

MR. RAMSAY: Right. So some would suggest that, you know, those contracts that the credit extension are embedded in the price but embedded in an opaque way, in a way that's not ideal and most efficient --

MR. TURBEVILLE: Really? I've never heard of that.

MR. RAMSAY: Some would suggest. So does that prompt any suggestions about in terms of the machinery of the clearinghouse, you know, representation of end-user interests? Is it appropriate to have a specific end-user representation on the board, on the risk
committee, on, you know, sort of a key --

MR. TURBEVILLE: Maybe more creative ways to -- I mean, I think this is all about credit. I mean, more creative ways to provide credit into the system so that credit for margining can be accessed. And the other thing is, of course, more -- less lack of transparency on the other side.

MR. PIRRONG: I just wanted to go to sort of the premise of your question which was about the markets being concentrated and there was sort of an implicit assumption there that they were too concentrated. Well, I think it's important to recognize, I think first of all we should ask the question, well, why did they get to be that way? There are fundamental economic factors that are driving that. What are those economic factors? I can think of some good ones and I can think of some bad ones. For example, sort of too big to fail subsidies could be one thing that would be encouraging excessive concentration.
But on the other hand, I can think of good just sort of economy and scale and scope reasons that are leading to this kind of concentration. And I think it's important to start from a fundamental understanding of what the economics are as opposed to saying, oh, the market is too concentrated. Let's force a less concentrated structure which might actually be sort of going against the underlying economics and force on excessive cost and perhaps excessive risk.

I think one of the -- one of the points that I hear raised often as well, is the standards for membership are too high. And there are sort of two factors on that. One is to talk about the financial requirements of, you know, net capital, and two is, points around the need to provide daily pricing for CDS clearing and to participate in the unwind upon the default of a counterparty. And I think you have to think about this in terms of, you know, the questions about what should be mandated and how far do we clear and questions
about this are directly tied together.

So the fundamental principle behind the clearinghouse is we have sufficient daily pricing that we can know what the variation margin should be. And by having sufficient daily pricing we're able to calculate an appropriate IM and an appropriate guaranty fund to ensure that we're safe. If we have products that are liquid enough in that clearinghouse that you don't need to rely on the members for daily pricing, then that's going to lead you to a different answer for what your membership standard should be. If you have products that aren't liquid enough, you know, if you look at some of the DTTC's statistics they have published on the nine month study that you guys did on trading volume, well below -- well more than half of the thousand single names they looked at had less than five trades a day across the entire curve. So on a 10-year curve, four points a year, 40 products per credit, there were less than five trades a day.

And the way I think about it is it
1 should be an open -- it should be open access but
2 you need to have certain standards to get a
3 driver's license. And those standards change
4 based on the type of vehicle you're driving. So
5 if you're just going to drive a car, there's one
6 set of standards. If you're going to drive a Mack
7 truck, there's a different set of standards. And
8 that means regulators kind of have a choice. And
9 I think part of this is, you know, what was
10 intended by Dodd-Frank. But if your choice is to
11 say we're only going to have clearing of the
12 highly liquid products, that's going to be a very
13 narrow interpretation of what's cleared and you're
14 going to end up with a broader set of those who
15 can handle the client risk that they're taking on
16 and they're introducing into the system and who
17 are able to participate in the risk management
18 system. And the mutualizing of that risk between
19 members.
20 If you go for a broader set of what's to
21 be clear, which I think seems to be what everyone
22 thinks is the intent of Dodd-Frank and certainly
from the approach of the clearinghouses is what they're targeting, then I think you have to set a narrower standard, you know, you have to set higher standards for who's able to participate in that. And that's all really based on this issue of how liquid are the products that we're clearing and do we have enough pricing externally that we don't need to rely on that from the members?

MS. JOHNSON: I will, I would just add that part of the concentration is certainly the result of the adoption of the Commodities Future Modernization Act in 2000 and the definition of eligible market participants, and/or in combination with the Gramm-Leach-Bliley Acts removal of those sort of into an unregulated zone. So I think some of the concentration was largely the part of legal construct limiting who could actually participate in the market. And that legal construct was based in part on what Tom is mentioning, the concerns about liquidity in the market and the ability of pension funds or other sort of more sensitive types of investors'
abilities to access the opportunity to liquidate the positions if they needed to in a particular emergency.

MR. RADHAKRISHNAN: I think there is another dimension to access. One is access to credit membership, which Tom just talked about. But he other dimension is the access of end-user or clients to having their products cleared. In the futures model everybody has access because you get no choice. Right? When you trade a futures contract you've got to clear it. Right? Either you do it directly or you do it through an intermediary. So the question I have is I believe that there is not enough client clearing for credit right now. And tell me if I'm wrong. And if I'm wrong, why is that so?

MR. DIPLAS: Well, we couldn't tell you it's wrong because there's not enough client clearing. So that's probably the easiest part of the debate today.

Look, I mean, we already -- the fact that credit clearing has taken us three or four
years to actually get it done is because it is totally complex. We're dealing with an underlying instruments complex. We have to work out a lot of issues. Obviously, the moment we introduce client clearing it raised the complexity by another order of mine because suddenly we are dealing with instead of three parties, you're dealing with four parties. Part of the issue we had was that actually we were dealing with participants in multiple legal jurisdictions and we had to face multiple backup (inaudible) trying to figure out how to work all of those.

Now, one good thing coming out of Dodd-Frank is actually because of the imposition, for example, of the FCM requirement is that it simplifies some of that framework and therefore now we can go back and deal with an easier framework and actually I think we're going to be more successful in that respect. So that's why it took so long but I think we have some concrete steps in front of us to actually get this done.

MS. TAYLOR: I think one of the issues
that we're all facing is that we're all trying to hit a moving target. A lot of what Tom said is very, very applicable. It definitely serves the customers better and it serves actually the clearinghouses better from a risk management point of view to have a more diverse group of clearing member participants as long as that diverse group of clearing member participants has the capacity and the expertise to perform the functions that we're asking them to perform. And right now the set of functions that we're asking a clearing participant in a CDS offering to perform include some functions that are probably not widely available. There isn't a huge universe of entities that are able to perform those functions. As the markets become more transparent, more widely traded, particularly certain products I think will become -- will adapt more readily to the electronic execution, I think we need to have a set of standards that will allow the market to evolve as -- the standards to evolve as the market evolves. In our particular case
we've got a much lower minimum capital hurdle to be a clearing member than other clearing providers for CDS. Over time, that's likely to be an operative hurdle. Right now I think the operative hurdle is the expertise and the capacity to perform things like participate in the pricing, participate in the default management, you know, stand ready to take your share of a portfolio that we need to liquidate. And there is not as large a universe of participants as we would like who are able to do those things. And I think that will change over time, but I would encourage you to think about that evolution as you try to set standards because you're trying to hit a moving target, too.

MR. EDMONDS: Yeah, on that point, someone calls you up and says -- I get these phone calls from time to time. I'm a SEF. Really?
Okay. And you have to provide open access because you're a clearinghouse. I'm like, I'm aware of what the statute says. But you haven't yet determined what a SEF is. And I draw that analogy
because as it relates to the buy side and the
interests they have, they are certainly interested
in the protections that are provided in a CCP and
the functions that collectively some of us in this
room provide. They haven't yet been able to, much
like you haven't been able to yet put your arms
around exactly what a SEF is, we'll kind of know
it when we see it, they know that that is coming.
They are anticipating the delivery of those
services, but yet they need to plan for that.
They need to understand what the requirement will
be on them. They need to understand what their
capital planning process, how it's going to be
modified and changed. Some of them will change
their business models and they will have to by
definition change the business models in which
they operate. We don't yet, to Kim's point about
a moving target, we have not yet provided enough
information. Dodd-Frank, the passage of that and
the execution is now law. The next step -- the
next iteration in this process is going to be the
rules that these agencies, your agencies develop
and provide. And we will look back on this in two years and go, well, it was all just, of course it was. We all just knew that.

But right now we're in the middle of mixing the batter, so to speak. And that is as frustrating for the buy side as it is for anyone else who is materially involved in this. But at least we've removed the uncertainty around whether or not we're going to have to or not going to have to. But that's only one piece of this puzzle that is a significant puzzle that we're all playing a piece in.

MR. CAWLEY: I'd like to discuss or respond somewhat to Kim and to Tom's comments about requirements for FCMs and the openness and what qualifies. I think certainly, you know, we're not suggesting for a second that there should be two sets of rules for two sets of FCMs. What we are saying is that yes, capital is an issue. And sophistication and the ability to trade and participate in the auction process in the event of an FCM is vital for the success of a
clearinghouse to operate. But there are, and I think you'll agree, several clearing brokers or FCMs out there in excess of 20 to 30, 40 billion capital who exceed your requirements who from a capital standpoint are certainly eligible to participate.

There's also innovative ways in which -- and Tom, to your point -- you can never have enough pricing when it comes to liquidity, when it comes to a liquidation situation. So if a clearinghouse is offered from other dealers who are seeking to enter the space who can provide liquidity and put their money where their mouth is and take some of that burden and wear some of that risk, I think it should behoove us all as an industry given the nature of this whole process that discourse should continue such that you bring in greater -- more pricing, more dealers, more FCMs to participate in the process.

When it comes to the auctioning of positions of a distressed FCM, I think it's fair to say that you can never have enough participants
in an auction. So you know, what I would suggest
and what we've contemplated is very simple, is
open up that auction process to include the buy
side. To include 400 to 500, 600 accounts. There
is precedent in the marketplace today where
auctions operate in a timely and efficient manner
when positions are auctioned off in the market
space today. So there is precedent out there.
There are many people who wish to participate in
these auctions. The buy side, new independent
dealers, L dealers of credit. There's a new
monopoly of information concentrated in a
particular few firms. So again, there are a
number of guys out there with capital who wish to
participate. There's a number of dealers out
there who wish to contribute prices who want to
share that burden. And indeed, there are a
number of buy side accounts out there who would love the
opportunity to participate in an auction,
especially as Matthias had mentioned very early on
that there should be some discount given in an
auction process. We don't think there should be
any discount given in an auction process. We think there should be a best price and that best price is assuredly optimized when you have 400 bidders in a room and not just six.

MR. DIPLAS: I think it's very important to go back to that point though. We're not talking about asking other people to come in and that is a problem. Clearly, when we have an auction the more people that come in the better. That's fine. What we are talking about is who is actually contractually obligated to participate in the auction? That is what the issue is here. Who is contractually obligated to price the stuff on a daily basis and participate in an auction. The problem we have in the situation such as Lehman defaulting is not that we have too many people actually participating in an auction; we have too few. That's the issue we have.

So if you want to come in and participate, everybody is welcome. If you come in with the same rights and the same responsibilities but you have to contractually be having the same
obligations. So there is no issue after that.

But to say that somehow if you cannot provide those services, that you might outsource them to someone else and they might be on the hook or might not be on the hook is a very uncertain situation and it makes it very uncomfortable.

MR. RADHAKRISHNAN: That will be -- that whole issue you just talked about is going to be a -- I hope will be a subject of another discussion. But unfortunately -- because it is a very -- it is a very important discussion as to the structure of clearinghouses and I'm not committing ourselves to another roundtable but I would like to have another sessions.

With that we have to end. I really would like to thank each and every one of you for your contributions. I think it helped us a lot. I know it was, you know, you took a lot of time off your busy schedules and we appreciate it very much.

Before I end, I would like to remind everybody -- I don't know if this is being webcast
but, you know, in the Federal Register release we
did invite comment and there are specific
mailboxes that you can send us your comments. And
also, when we do come out with our respective
agencies' comment on the rulemakings, we hope that
you will comment.

But thank you very much. We will
adjourn for now and 1 o'clock is the next
roundtable. So thank you.

(Whereupon, at 12:07, the
PROCEEDINGS were adjourned.)

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