

COMMODITY FUTURES TRADING COMMISSION
SECURITIES AND EXCHANGE COMMISSION

PUBLIC ROUNDTABLE ON
GOVERNANCE AND CONFLICTS OF INTEREST
IN THE CLEARING AND LISTING OF SWAPS

Washington, D.C.

Friday, August 20, 2010

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

2 (9:00 a.m.)

3 MR. RADHAKRISHNAN: Good morning. My
4 name is Ananda Radhakrishnan. I am the director
5 of the Division of Clearing and Intermediary
6 Oversight at the CFTC.

7 I am pleased to open the Joint CFTC-SEC
8 Public Roundtable to discuss issues related to
9 governance and conflicts of interest in the
10 clearing and listing of swaps and security-based
11 swaps. This discussion this morning is divided
12 into two panels. The first concerns types of
13 conflicts while the second concerns possible
14 methods for mediating conflicts. We have what we
15 hope is a comprehensive agenda that is designed to
16 focus a discussion.

17 We have a distinguished group of
18 panelists, both for Panel 1 and Panel 2, and I'd
19 like to thank them for agreeing to participate.

20 I'd also like to thank the staff of the
21 SEC and the CFTC for their hard work in planning
22 this roundtable. This roundtable is only one

1 example of the close and collaborative
2 relationship that the staff of the CFTC has
3 developed with the staff of the SEC, and we hope
4 that this will continue to flourish.

5 The Dodd-Frank Act for the first time
6 brings over-the-counter derivatives under
7 comprehensive regulation. It requires
8 standardized derivatives to be traded on
9 transparent trading platforms and to be cleared by
10 robustly regulated central counterparties. This
11 will greatly reduce the risk in our economy and
12 will benefit the American public. Identifying and
13 mitigating conflicts of interest that may impede
14 such trading and clearing is crucial for such
15 benefits to be achieved. Therefore, we look
16 forward to hearing the thoughts and analyses of
17 those on the panels. The roundtable should assist
18 both the SEC and the CFTC in implementing the
19 Dodd-Frank Act.

20 Now, for the record, I wish to state
21 that all statements and opinions that may be
22 expressed and all questions asked by CFTC staff

1 are those of CFTC staff and do not represent that
2 views of any commissioner or the Commission,
3 collectively. And before I invite my colleague,
4 Robert Cook, some housekeeping items with respect
5 to technology.

6 Everybody should know that the meeting
7 is being recorded. The microphones that you have
8 in front of you, press the button in front of you,
9 and you'll see the red light. That means you can
10 talk, speak directly into it. When you finish,
11 please press the button again to turn off the
12 microphone. And, finally, please refrain from
13 putting any BlackBerry or cell phones on the table
14 as they have been known to cause interference in
15 the audio system.

16 And now it gives me great pleasure to
17 invite my colleague, Robert Cook, to make opening
18 remarks. Thank you.

19 MR. COOK: Thanks, Ananda. Good
20 morning, I'm Robert Cook. I'm the director of the
21 Division of Trading and Markets at the FCC, and
22 it's my great pleasure to be here today with my

1 fellow staff members from the CFTC and the SEC.

2 I'd like to start by thanking the CFTC
3 and its staff for hosting and organizing the event
4 this morning, the first in a series of roundtable
5 discussions concerning the implementation of the
6 Dodd-Frank Wall Street Reform and Consumer
7 Protection Act. I'd also like to echo Ananda's
8 comments about the very close working relationship
9 we have between the two staffs and the great
10 pleasure it gives me to be part of that, and I
11 look forward to continuing to have a very
12 productive and fruitful dialogue with them.

13 I would also like to extend our
14 appreciation to the panelists this morning, who
15 are with us to share their insights, advice, and
16 recommendations. We're truly grateful for your
17 participation in this roundtable and for your
18 willingness to share your views with us. Your
19 participation today will help us as we move
20 forward in faithfully and fully implementing the
21 provisions of the Dodd-Frank Act.

22 Just by way of housekeeping matters as

1 well, I will repeat the same disclaimer that
2 Ananda just gave, that any opinions, views,
3 questions from which opinions might be inferred or
4 otherwise from the SEC staff reflect merely staff
5 opinions and do not reflect the opinions of any of
6 the Commission, of the SEC, the commissioners or
7 any of our other colleagues on the staff of the
8 Commission.

9 I would also like to point out that this
10 is not the only opportunity for interested parties
11 to have input on these important matters. Both of
12 the agencies have open mailboxes into which anyone
13 from the public can submit comments and supporting
14 materials. And they will be read through by the
15 staff, and we very much encourage people to take
16 advantage of that. We really want to get broad
17 input into not only the conflicts rulemaking that
18 we were talking about today, but all the
19 rulemakings related to the implementation of
20 Dodd-Frank.

21 So with that I'll hand it back over to
22 Ananda.

1 MR. RADHAKRISHNAN: Thanks, Robert.
2 Before we start the panel, I'd like to go through
3 the agenda. We have two panels. The first panel
4 deals with types of conflicts and there are three
5 discussion items. And I'm the designated
6 timekeeper, so make sure that we stay on time. So
7 between now and 9:45 we're going to talk about
8 securities clearing agencies and derivatives
9 clearing organizations, specifically topics
10 relating to access to clearing, the determination
11 of swaps are legible for clearing, and risk
12 management.

13 9:45 to 10:15, Security-Based Swap
14 Execution Facilities and Swap Execution
15 Facilities. Again the issues will be access to
16 trading, determination of swaps eligible for
17 trading, and the potential for competition with
18 respect to the same swap.

19 And then from 10:15 to 10:45, Designated
20 Conflict Markets and National Securities Exchanges
21 topics. That will be the listing of swaps and the
22 comparison with conflicts of interest for swap

1 execution facilities and security-based swap
2 execution facilities, similarities, and
3 differences.

4 Then we go on at 10:45 to Panel 2, which
5 concerns possible methods for remediating
6 conflicts.

7 10:45 to 11:05, Ownership and Voting
8 Limits. 11:05 to 11:25, Structural Governance
9 Arrangements. Here the specific sub-topics will
10 be independent or public director requirements for
11 board and board committees, consideration of
12 market participant views with respect to DCOs and
13 designated contract markets, the fair
14 representation requirement in the Securities
15 Exchange Act, and other governance matters such as
16 transparency.

17 11:25 to 11:45, Substantive
18 Requirements, Membership Standards, Impartial
19 Access Requirements.

20 And 11:45 to 12:00, Appropriateness of
21 Applying the Same Methods to Each Type of Entity.

22 And we hope to conclude the roundtable at 12

1 o'clock. You will notice there is no room for
2 breaks, so -- and that's because of the time we
3 have.

4 So before we start Panel 1, I would like
5 to invite the panelists to, you know, introduce
6 themselves and let us know where they're from. So
7 we'll start with Jonathan Short.

8 MR. SHORT: Jonathan Short,
9 Intercontinental Exchange.

10 MR. NAVIN: Bill Navin, the Options
11 Clearing Corporation.

12 MR. OLESKY: Lee Olesky, Tradeweb.

13 MR. HILL: James Hill, Morgan Stanley,
14 on behalf of the Securities Industry and Financial
15 Markets Association.

16 MR. KASTNER: Jason Kastner, vice
17 chairman, Swaps and Derivatives Market
18 Association.

19 MS. SLAVKIN: Heather Slavkin, AFL-CIO.

20 MR. BERNARDO: Shawn Bernardo, Tullett
21 Prebon, on behalf of the Wholesale Market Brokers
22 Association.

1 MR. DeLEON: Bill DeLeon, Kinko.

2 MR. RADHAKRISHNAN: Go ahead.

3 MR. DUFFIE: And Darrell Duffie of
4 Stanford University.

5 MR. KROSZNER: And Randy Kroszner,
6 University of Chicago, Booth School of Business.

7 MR. SHORT: I would like to echo my
8 thanks to all the panelists for participating here
9 today.

10 I would start off by asking just
11 basically what do you see as being the primary
12 sources of conflicts within clearing AGs and DCOs,
13 and specifically those that clear swaps and
14 securities-based swaps, and I open this question
15 up to all the panelists.

16 MR. KASTNER: Again, Jason Kastner from
17 the SDMA. I think one of the fundamental issues
18 which is well- addressed in the law in Section 725
19 is the issue of fair and open access. The SDMA is
20 a strong proponent of central clearing. We
21 believe that anything that can be cleared should
22 be cleared. We also believe that economic

1 interests should be set aside to mitigate systemic
2 risk and protect the American public against
3 further financial calamity.

4 In order to do that, it is more
5 efficient to bring transparency and open access
6 and to allow more participants into the market to
7 diversify risk. We must remember that the
8 essential point of the Dodd-Frank Act is to
9 address the issue of too big to fail and too
10 interconnected to fail. And by permitting
11 unfettered access to clearing and bringing in more
12 participants, we address those risks and help
13 protect the American public.

14 MR. SHORT: I would like to share ICE's
15 perspective on this issue. Certainly open access
16 is an important part of the Dodd-Frank Act, but it
17 is certainly not the primary driver of the Act. I
18 think one of the biggest conflicts that has to be
19 addressed here is the conflict between open access
20 and proper risk management of the clearinghouse.
21 And one of the things that I think has to happen
22 is that people need to step back and consider that

1 clearinghouses are going to be the ultimate
2 repositories for all of the systemic risk that was
3 previously dispersed throughout the market.

4 And one of the things that I think needs
5 to be carefully considered is the clearinghouses'
6 obligation to manage that risk and perhaps the
7 limitations that have to be placed on SEFs or
8 other market participants in their access to the
9 clearinghouse. I'm not saying that that
10 eviscerates open access -- it certainly doesn't --
11 but I think there's the balance there, and the
12 members of the clearinghouse are ultimately the
13 parties that are underwriting this risk and
14 responsible for it.

15 MR. HILL: I wonder if I could just add
16 to that. This is Jim Hill from Morgan Stanley. I
17 think there's two parts to access: The first is
18 we certainly agree that every customer who is
19 transacting -- every individual and customer who's
20 transacting in OTC derivatives should have access
21 to a clearinghouse, should be able to clear their
22 trades through a clearinghouse. That goes without

1 saying that's required by the law. I think
2 everyone in this room probably agrees that that's
3 clearly the case.

4 But the second piece of this is who
5 should be a clearing member. And that's where we
6 get into the risk management issues of the
7 systemically important clearinghouses, and the key
8 thing that people need to think about is when once
9 all these OTC derivatives are concentrated in the
10 clearinghouse, what is the purpose of the
11 clearinghouse? The purpose is if one of the
12 clearing members were to default and become
13 insolvent, the risk needs to be absorbed by the
14 other clearing members.

15 And the way that risk is absorbed is
16 twofold. The first is the surviving clearing
17 members put capital into the clearinghouse, so
18 they have to have a sufficient capital base so
19 that they can put capital into the clearinghouse
20 in a time of crisis.

21 And two, and perhaps even more
22 importantly, they have to be able to absorb the

1 positions, the risk positions of the defaulting
2 member. So, for example, if an entity like Lehman
3 Brothers is a clearing member in the clearinghouse
4 and it defaults, in order for the clearinghouse to
5 remain flat risk and itself not become insolvent
6 the risk of the OTC derivatives, the economic
7 risk, needs to be replaced. And the way it gets
8 replaced is the surviving clearing members enter
9 into transactions, OTC derivatives, with the
10 clearinghouse to replace that market risk.

11 So not only do you need to have clearing
12 members who have enough capital, you know, to
13 recapitalize the clearinghouse if a member
14 defaults, but they have to be able to keep the
15 clearinghouse flat from an economic risk
16 perspective, which means they have to be able to
17 trade very large amounts of very highly complex
18 illiquid OTC derivatives. And if they can't do
19 that, by introducing them as a clearing member
20 into the clearinghouse, you actually increase risk
21 in the clearinghouse because at a time when a
22 member is defaulting, the clearinghouse won't be

1 able to absorb the losses.

2 And that is critical. And if we don't
3 get that right, we end up with clearinghouses
4 that, where all this risk is concentrated, that
5 are inappropriately risk- managed.

6 MR. OLESKY: Lee Olesky from Tradeweb.
7 I guess I have a slightly different perspective
8 I'd like to raise which has to do with a potential
9 conflict when a clearinghouse is both a
10 clearinghouse and also an exchange venue. As we
11 see in the futures markets and other markets, if
12 you have both execution and clearing, we think
13 it's very important for there to be a competitive
14 environment among execution venues. And in order
15 to have that competitive environment among
16 execution venues, that requires really equal and
17 fair access from any execution venue into a
18 clearing corp.

19 So it's a slightly different slant on
20 what everyone's been saying to this point, but
21 from an execution venue standpoint we think it's
22 really critical for there to be a competitive

1 environment so that we can access the central
2 counterparties.

3 MR. NAVIN: This is Bill Navin from OCC.

4 MR. DeLEON: Bill DeLeon from Kinko. I
5 think, you know, there definitely is some very
6 good points here, and I'd like to first bring up
7 the issue (inaudible).

8 MS. SCHNABEL: I'm sorry, Bill, you're
9 breaking up a little bit. Can you -- we're having
10 some echoes. Can you make sure that there are no
11 BlackBerrys where you are?

12 (Interruption; speakerphone
13 malfunction)

14 MS. SCHNABEL: Heather, would you like
15 to say something while we're waiting for
16 (inaudible)?

17 MS. SLAVKIN: Sure. What I was starting
18 to say earlier is that I think -- I'm sorry, can
19 you hear me now?

20 What I was starting to say earlier is
21 that I think in addition to the access question
22 there's a concern generally about who owns and

1 controls the clearinghouses. If there's an
2 interest among the people who own the
3 clearinghouse, or a conflict of interest that
4 would create incentives for them to also favor,
5 you know, now allowing certain types of swaps to
6 clear because they may be more profitable for the
7 institution generally if they remain over the
8 counter, then that can create perverse incentives
9 to maintain the over-the-counter, nontransparent,
10 systemically risky markets when the goal needs to
11 be to prevent those conflicts of interest to
12 ensure that anything that can be cleared does, in
13 fact, clear.

14 MR. HILL: I wonder if I could respond
15 to that. I think there's a bit of a misconception
16 that somehow clearing makes trades less
17 profitable. That's clearly not the case. In
18 fact, I think most of the large systemically
19 important participants in this market prefer
20 clearing. And I think that's not just a
21 statement; there is significant anecdotal evidence
22 to support that perhaps the most important of

1 which is LCH.

2 LCH is one of the main clearinghouses
3 for interest rate derivatives. It was founded, at
4 least with respect to interest rate swaps, over I
5 think it was nine or ten years ago. They're
6 currently clearing \$230 trillion of interest rate
7 swaps. There was no law that required LCH, you
8 know, for people to use LCH for clearing. There
9 was never regulatory encouragement or mandate of
10 any sort; it was formed by consortium of dealers
11 to mitigate the counterparty risk. And it was
12 done because from an economic perspective it was
13 deemed to be prudent as well as risk reducing, and
14 to suggest, then, somehow that people, that
15 dealers purposefully created LCH 10 years ago to
16 reduce their own profits doesn't really make
17 sense. It was reduced to -- it was introduced to
18 reduce risk.

19 And so, and as I said, you know, it's
20 clearing currently \$230 trillion of interest rate
21 swaps, so it's hard to imagine why that would have
22 happened if it actually reduced profits.

1 MR. DUFFIE: This is Darrell. Can I
2 follow up on that, please?

3 MR. HILL: Please.

4 MR. DUFFIE: I agree with the idea that
5 incentives are already aligned for a large amount
6 of clearing. And as we attempt to get more
7 counterparty exposures cleared, the issue arises
8 of conflicts over what types of financial products
9 must be cleared. The interest rate swaps is a
10 good example of where regulatory pressure is not
11 needed. As we move into additional products or
12 more types of interest rate products, there are
13 two approaches. One that's been suggested for
14 Europe is for regulators to define what products
15 will be standardized and cleared.

16 Another approach which I would advocate
17 in order to reduce conflicts of interest and
18 maintain the incentives that were just described
19 is to increase the pressure for more clearing in
20 general and allow the market participants to
21 decide what particular products to clear. That's
22 important because there's, if regulators should

1 make a mistake in their best efforts and define
2 products for clearing that are not appropriate,
3 first of all not enough clearing will occur, and,
4 secondly, there will be some spurious
5 customization of products that's designed to avoid
6 the clearing of products that are not economical
7 for markets to clear.

8 So I would advocate to use the capital
9 requirements and collateral requirements to
10 encourage more clearing rather than defining what
11 specific products must be cleared.

12 MR. BERNARDO: Shawn Bernardo on behalf
13 of the Wholesale Markets Association. I'd like to
14 echo what Lee Olesky said, which is that we've
15 seen entities or exchanges that have both
16 execution and clearing, that it's not just a
17 concern, but we've actual experience where you
18 don't have fair and open access to the clearing
19 and in the space that we're in, which is the
20 execution of SEFs, if we don't have fair and open
21 access to that clearing, it's a concern and it
22 creates an issue for us moving forward.

1 MR. NAVIN: Bill Navin from OCC. Our
2 model is one that does provide equal access from
3 execution venues to the clearinghouse. While our
4 stock is owned by Exchanges, we're controlled by
5 the Street. Nine of our 16 directors are drawn
6 from our clearing members, and over the last
7 nearly 40 years we found that that's been a
8 successful model.

9 I think it's important that, while there
10 are certainly conflicts of interest that need to
11 be taken into account, at the end of the day,
12 effectively the capital of the clearinghouse is
13 supplied by the membership, and the risk is borne
14 out by the membership. And, therefore, it seems
15 to us only fair that the membership should have an
16 active role in determining how that risk gets
17 managed.

18 MR. KASTNER: Jason Kastner again from
19 the SDMA. I'd like to opine, if I may, on
20 something that Jim Hill discussed with regards to
21 the LCH. The LCH is a closed system. It requires
22 that one have not only \$5 billion of net capital

1 but \$1 trillion if swaps already cleared.

2 Now, how does one join a clearinghouse
3 if they require that you already have cleared \$1
4 trillion of swaps? So the idea is again to bring
5 more members, qualified members, well-capitalized
6 members. But allow me to take an example of a
7 very large clearing bank that clears \$21 trillion
8 of treasuries who is not allowed to become a
9 clearing member of the LCH, one of our member
10 firms.

11 Now, if we're going to be really clever
12 about keeping people out of the system, the system
13 is not going to work effectively. We're going to
14 have the same OTC style, bilateral, closed,
15 untransparent, opaque, risky system. And what we
16 need to do is allow more entrants to diversify
17 risk, address too big to fail and too
18 interconnected to fail.

19 Secondly, I'd like to also say that it's
20 not only about membership of a clearinghouse; it's
21 about access to clearing services as a sort of
22 introducing broker. So one of the other tenets of

1 the LCH is that one must, to be a party to a
2 trade, one must be a clearing member of the LCH.
3 And what we would support at the SDMA is a system
4 whereby a member firm of the SDMA could use an LCH
5 member firm as their sort of SCM, Swap Clearing
6 Member, but actually take the execution risk,
7 because there's a difference here between
8 execution and clearing. And by time, inexorably,
9 we're not addressing the issue of systemic risk.

10 MS. SCHNABEL: I have a quick question.
11 I think one of the key issues that we've
12 identified so far is the balance between open
13 access and risk management, and to play off what
14 Jason has just said about LCH and the requirements
15 to become a clearing member such as \$5 billion in
16 capital and \$1 trillion in transactions cleared, I
17 was wondering, I guess, how is the balance struck
18 currently between open access and risk management?
19 Because I was wondering if anybody can have a
20 perspective on how these requirements came about.
21 I mean, why would \$5 billion be necessary for risk
22 management, or \$1 trillion in transactions

1 cleared?

2 MR. HILL: I don't want to speak to any
3 specific clearinghouse because I'm not sort of
4 intimately familiar with any of the very detailed
5 rules of each of the clearinghouses. But, I mean,
6 as -- again, as a general rule, the clearing
7 member needs to be able to absorb losses, a
8 default by another clearing member, number one;
9 and, number two, they need to be able to absorb
10 the economic transaction risk in the portfolio of
11 a defaulting member.

12 And so the way these clearinghouses set
13 up their risk, you know, their admission or their
14 membership criteria, is both of those things. So,
15 A, they have to have a capital base sufficient to
16 absorb losses and add in more capital to the
17 clearinghouse if a member defaults. And B, they
18 have to be able to in a situation where a clearing
19 member has defaulted, which is probably the time
20 of most economic stress, you know, in the economy,
21 be able to take down the economic transaction risk
22 of the swaps that were otherwise, the defaulting

1 member was otherwise a party to, those trades need
2 to be allocated among the surviving clearing
3 members.

4 And so the way these clearinghouses
5 developed their criteria is they look at both of
6 those prongs and they set thresholds to make sure
7 that the members who are admitted can do those
8 things. Because, remember, if you admit a member
9 who can't do both of those things, then what
10 happens is the clearinghouse will have
11 insufficient capital in a situation where a member
12 has defaulted, which is the time of the highest
13 economic stress.

14 And so I mean perhaps, you know, a panel
15 of the sort of risk managers of each of the major
16 clearinghouses would be able to address that more
17 specifically. But I think ultimately that's the
18 framework on which they make decisions.

19 MR. RADHAKRISHNAN: Now, I know Randy
20 Kroszner was trying to make a point earlier on,
21 and it's audio issues.

22 Randy, can you hear us, and would you

1 like to make your point again?

2 MR. KROSZNER: I'm having difficulty
3 hearing you, and so I apologize on that. Can you
4 hear me?

5 MR. RADHAKRISHNAN: Yes, we can. Thank
6 you.

7 MR. KROSZNER: Okay, great. Well, first
8 I wanted to underscore what Darrell Duffie had
9 said. I think that in terms of thinking about the
10 determination of what's possibly eligible for
11 clearing, we want to think about giving strong
12 incentives through cap requirements, collateral
13 requirements, but not necessarily mandating each
14 individual -- contracting each individual product.

15 On the -- with the conflict of interest
16 that you're talking about of being really getting
17 to the heart of the issues that clearinghouses
18 have been struggling with since they started to
19 function as the guarantors of the contracts back
20 in the late 19th century of getting the balance
21 right between having access -- well, a combination
22 of having access and having clearing members,

1 making sure that there are enough members, making
2 sure there's enough trading and drawing things off
3 the Exchange, but also ensuring that those members
4 have the wherewithal to withstand the shocks to
5 make the clearinghouse something that will reduce
6 system risk, reduce interconnectedness rather than
7 increase it.

8 And so I think these are exactly the
9 very questions to be focusing on. Unfortunately,
10 I couldn't hear a little bit of some of the
11 specifics, so is there something in particular
12 you wanted me to comment on?

13 MR. RADHAKRISHNAN: No. One of the
14 questions that was asked -- I don't know if you
15 heard it -- was how do you find the balance
16 between open access, fair access, and the desire
17 for the risk management considerations: One, are
18 decisions being made purely on risk management
19 reasons and not, you know, anti-competitive or
20 pro-competitive reasons? So how do you find the
21 balance?

22 And one of the issues is, if you have a clearinghouse,

1 if I understand the discussion, if you have a
2 clearinghouse that's dominated by a group of people --
3 I won't tell you who they are, but dominated by a
4 group of people -- does that achieve the objective of
5 fair and open access, or -- well, I guess the question
6 is which should prevail? Ideally, both should
7 prevail, but, you know, that you avoid conflict of
8 interest but at the same time you make sure that all
9 decisions are being made by the clearinghouse
10 according to its risk management.
11 So if you care to share your thoughts with us on that,
12 we'd appreciate it.

13 MR. KROSZNER: The law is very clear on
14 what should prevail. It is rife within the law
15 open access, fair, open, unfettered access,
16 transparency. Risk management is better done in a
17 default scenario if there are more members
18 participating in an auction. And to say that an
19 SDMA member firm that that clears \$21 trillion of
20 treasuries is somehow ineligible or unqualified to
21 be a member of whatever clearinghouse is not
22 addressing the issues properly.

1 And I would also like to point out
2 Section 731 on page 342 of the Dodd-Frank Act
3 which discusses this issue in a different way in
4 regards to conflicts of interest right after Risk
5 Management Procedures. It requires that banks
6 establish structural and institutional safeguards
7 and supervisory barriers and informational
8 partitions between those who trade and those who
9 provide clearing services.

10 So this is what we call in the SDMA's
11 "the Chinese Wall provision." This is a very good
12 provision because it goes directly to this issue
13 of the conflict between trading and clearing.
14 Because, currently, annually, there's estimated to
15 be about 3- to \$500 million made clearing, and
16 there are between 40- and \$60 billion being made
17 trading. So this discussion of clearing and
18 access to clearing is really just a proxy about
19 access to trading, because that's where the
20 revenues are. And the law is clear: Open access
21 is the fundamental principle.

22 MR. RADHAKRISHNAN: And keep in mind if

1 you have a --

2 MR. DeLEON: This is Bill DeLeon, can
3 you hear me?

4 MR. RADHAKRISHNAN: Yes. Yes, yes.

5 SPEAKER: Say, can you let Bill speak
6 first, just because he was cut off earlier?

7 MR. DeLEON: Thank you very much. I
8 find all this very interesting and there's some
9 very good points here. In terms of, you know,
10 (inaudible) to you and sort of concerns in
11 general, I think it's important to separate
12 clearing and access to clearing and what it
13 represents in terms of (inaudible) risk.

14 Our view has been that clearing should
15 be viewed as a utility where all members who use
16 it have access to clear as well as to reduce
17 systemic risk. And in order to reduce systemic
18 risk, the member or firms who are supporting the
19 Exchange or the clearing mechanisms need to be
20 able to have sufficient capital. And it's
21 important to note that sufficient capital to
22 support is not -- come out of this with clearing

1 trade. It means actual capital is being
2 supported. And whatever, you know, that view is
3 the important differentiation because the
4 mechanism where the trades are cleared has to be
5 sufficiently strong and risk managed such that
6 when you look at the members backing the Exchange,
7 you're comfortable that both the member you're
8 using for clearing as well as the overall clearing
9 mechanism have sufficient capital to withstand a
10 default by either a member or by a user of it.

11 So this is the important thing, is we
12 view it as a utility function with correct risk
13 management need. Who becomes a member should be a
14 function of being able to provide the capital and
15 support a member default because, ultimately,
16 there is still commingled counterparty risk going
17 on. And that is the important differentiation,
18 you know. I, personally, wouldn't want to see,
19 you know, anyone on this as a personal clearing
20 member because I don't think anyone personally has
21 enough capital to go in. But their firm, it's a
22 question of how much capital they have when they

1 go in to support. There shouldn't be a club or a
2 group, it's the utility, so I think that's
3 important.

4 And then to the clearing and the trading
5 execution, I think that's a very important thing,
6 And I know that one of the later panels is going
7 to talk about transparency and that information.
8 But I think it's very important to separate the
9 two things of clearing versus trade execution.
10 What's the most important thing from our
11 standpoint is that the trades get done, and once
12 they're done that they'd be able to be cleared.
13 That is how you mitigate risk is getting the
14 trades turned into a TCP where there is risk
15 management and there is sharing and margining, and
16 it's been moved into a utility function as opposed
17 to the opaque bilateral agreement whereby no one
18 -- you know, only regulators can sort of figure
19 out what's going in after the fact.

20 So those are sort of our big things.
21 And I think that the risk management and ability
22 of the Exchange to -- or the CCP to handle and

1 have members who can support the capital is the
2 important thing.

3 MR. RADHAKRISHNAN: Shawn, you have a
4 response?

5 MR. BERNARDO: I just wanted to point
6 out again that if you have a clearing firm that
7 charges fees for that clearing and then you have
8 that same clearing firm has an execution venue
9 that competes in the interdeal broker space, which
10 is what we do, or as which is we create and we
11 operate fair open access to our markets, it's
12 transparent, and we charge a fee for what we do,
13 that clearing firm can who's also executing or
14 allowing people to execute on their trading venue,
15 not charge a commission. Basically, which you
16 would not create a competitive or force a
17 competitive atmosphere with what we're doing, and
18 at some point in the future turn that commission
19 back on for the execution.

20 So you can execute now on our platforms
21 and compete, whereas a clearing firm can turn
22 around and say, okay, we're not going to charge

1 for execution, we're just going to charge for
2 clearing. So that open access is, it's just not
3 there. It's --

4 MR. RADHAKRISHNAN: It doesn't mean --

5 MR. BERNARDO: A competitive and fair
6 environment.

7 MR. WORKIE: I'm sorry, Dodd-Frank asks
8 us to think about restrictions with respect to
9 swap participants, major swap participants, bank
10 holding companies and nonbank financial
11 institutions, and when we're thinking about
12 conflicts and potential restrictions, how should
13 we think about them, either collectively within
14 that group, or individually within those
15 subgroups?

16 And just as a follow-up, does it make a
17 difference if there are actually numbers of the
18 clearing agency or DCO, or not when we think about
19 these conflicts? And I imagine it would, but just
20 I'd like some opinions on that.

21 MR. KASTNER: Well, I would refer you to
22 Section 726 where it's sort of -- I call it Lynch

1 Light. You know, it was the Lynch amendment that
2 now the Commission is to take under consideration
3 certain ownership and control restrictions in
4 DCOs. And I would say that the SDMA strongly
5 supports restrictions on ownership and
6 restrictions on control in DCOs, and the reason
7 why is because if you have a club which is closed
8 which controls not only what goes into the
9 clearinghouse but who can become a member of it,
10 it doesn't address the issues of too big to fail
11 and too interconnected to fail.

12 So I would strongly suggest and highly
13 recommend that well the Commission considers the
14 implementation over the next 180 days of Section
15 726, that they do move forward and impose
16 restrictions because, if they're not, there is a
17 real risk that we're going to end up right back
18 where we started again.

19 MS. GREGORY: I have a question. What
20 types of conflicts -- oh, I'm sorry. Okay.

21 What types of conflicts of interest have
22 arisen, or made potentially arise, in the

1 operation of a DCO with respect to determining
2 which swaps are eligible for clearing?

3 MS. SCHNABEL: I believe that Heather
4 spoke a little bit about that, but we would like
5 to, you know, if you could just expound.

6 MS. SLAVKIN: I think that there's the
7 risk that anything that could be made to appear to
8 be something that is a bilaterally contract, you
9 could have the spurious customization issues, if
10 there's the opportunity to get additional profits
11 within the big dealer banks, and those same dealer
12 banks are running and controlling the
13 clearinghouses, then, you know, the potential for
14 spurious customization becomes a real issue and
15 becomes a possibility.

16 MS. GREGORY: So that's --

17 MS. SCHNABEL: Sorry. Multiple times, I
18 think I've heard concerns raised about the
19 potential tying of execution and clearing. And I
20 guess one concern that I've heard and maybe
21 somebody can address it or speak more to it, is
22 that with respect to clearing, I mean, the

1 clearinghouses would determine what swaps would be
2 cleared and then, because of Dodd-Frank, the
3 clearinghouse -- I mean the swaps that would be
4 determined could be cleared, maybe listed on a SEF
5 or a DCO.

6 And so it seems as if, perhaps, the
7 circumstances surrounding clearing now may be
8 slightly different than what have previously
9 happened when LCH was first formed, for instance
10 by the interdealer banks, and I was wondering if
11 somebody can speak more to perhaps the shifted
12 circumstances between then and now and what the
13 incentives and what the conflicts of interest are
14 for eligibility of clearing.

15 MR. HILL: Yeah, we -- it is our view
16 that -- and I think Dodd-Frank requires this --
17 that clearinghouses be agnostic as to where they
18 accept trades from, so clearinghouses should be
19 open to any SEF. You know, we believe there will
20 be multiple SEFs in the marketplace from, you
21 know, for multiple products, and the
22 clearinghouses should accept trades from multiple

1 SEFs which is consistent with the statute's goal
2 of increasing clearing. And we also believe that
3 SEFs should be clearing agnostic as well, meaning
4 that SEF should feed in, you know, should be
5 allowed to -- should be set up so as to allow the
6 people using the SEF to choose which clearinghouse
7 they want to go to.

8 So that clearinghouses should be
9 agnostic and the SEFs, themselves, should be
10 agnostic. That will, without question, ensure
11 that the maximum amount of clearing that can occur
12 will occur.

13 Going back to the point about who should
14 decide what gets cleared, I want to emphasize
15 that. I don't think the assumption that somehow
16 clearing hurts profits is correct. I just don't
17 think that's correct, and I haven't really heard
18 any explanation as to why people think that. But,
19 more importantly, again the members of the
20 clearinghouse -- and we believe anybody who has
21 the capital and the expertise to evaluation risk
22 should be allowed to be a member, so we share that

1 view with, you know, some of the other members
2 here.

3 But in terms of whether or not those
4 clearing members should have a say in what gets
5 cleared, the key I think for people to remember is
6 that the clearing members themselves are the ones
7 who capitalize the clearinghouse.

8 So with respect to all the
9 clearinghouses that are out there for OTC
10 derivatives, the clearing members have the
11 overwhelming preponderance of capital in the
12 entity. So, for example, XYZ clearinghouse, the
13 clearing members may have put in \$5 billion. The
14 clearinghouse itself probably has about, you know,
15 20- to \$50 million. So the overwhelming
16 preponderance of capital in the clearinghouse is
17 put up by the clearing members.

18 In evaluating what trades should be
19 cleared, there's a balance that needs to be struck
20 between the goal of increasing clearing,
21 obviously, but, B, you don't want to put trades in
22 the clearinghouse that can't be appropriately

1 risk-managed. So if you put trades in the
2 clearinghouse that are illiquid and can't be
3 valued properly, what will happen is when a
4 clearing member defaults, there will be
5 insufficient collateral with respect to that trade
6 because it wasn't properly valued in the
7 clearinghouse, and the surviving clearing members
8 will be stressed from an economic perspective in
9 taking positions the value of which cannot be
10 readily ascertained.

11 So it's critical that only trades that
12 can be appropriately risk-managed be put into the
13 clearinghouse. And I think what you'll see is
14 that most of the clearinghouses look to their
15 clearing members to help them value which trades
16 are appropriate from a clearing perspective, and
17 that is completely consistent with the economic
18 incentives because the clearing members are the
19 ones who have the overwhelming preponderance of
20 the capital in the clearinghouse. So it's their
21 capital that's at risk. They should certainly
22 have a say in helping the clearinghouse evaluate

1 which trades are acceptable for clearing and which
2 trades are too risky or can't be valued, or are
3 too illiquid or not standardized and, therefore,
4 shouldn't be cleared.

5 MS. SCHNABEL: James, I have a quick
6 question. When you say that it's the capital of
7 the clearing members that are at risk, do you make
8 a differentiation between margin and default fund?

9 MR. HILL: I'm speaking of the default
10 fund when I say that.

11 MS. SCHNABEL: Okay, so margin is still
12 the first line of defense, and that, you know, can
13 be provided by customers as well?

14 MR. HILL: Correct. But when, in a
15 situation where a clearing member is defaulting
16 and markets are illiquid, if the margin is
17 insufficient, then you look to the default fund to
18 make sure the clearinghouse stays solvent.

19 MS. SCHNABEL: Jonathan and Bill, sorry,
20 just a quick question. I mean from your
21 experience in clearing, how many times have a
22 default -- or has a default caused access to the

1 default fund, do you know?

2 MR. OLESKY: In our case, once back in
3 1987, and it was for a relatively trivial amount
4 but it's something that you always have to be
5 concerned about. And when you're talking -- we
6 clear Exchange-traded products that are relatively
7 liquid. I think when you start talking about
8 over-the-counter products that can be complex and
9 relatively illiquid, then you have to worry more
10 about whether your margining system properly
11 values them, and you have to be more concerned, I
12 think, that you may need to have access at some
13 point to your default fund.

14 And I second Mr. Hill's comments. I
15 think that it's very important that the people who
16 bear the risk and supply the capital should have a
17 substantial voice in how that risk gets managed,
18 and that includes what contracts are accepted for
19 clearing.

20 MR. KASTNER: May I please, upon --
21 first of all, allow me to address something that
22 Jim said. He keeps saying that, you know, there's

1 no money to be lost here, that clearing doesn't --
2 you know, there's no economic disincentive to
3 preclude membership or keep things out of the
4 clearinghouse, and again it's not about clearing;
5 it's about execution. If you look at the BIS, 96
6 percent of the swap market is executed by the
7 largest 10 banks. I think they call that an
8 oligopoly. And the notion is if you introduce
9 more competition into that 40 to 60 billion
10 dollars which are at risk or being earned by
11 execution, that's where the pushing and shoving
12 begins. It's not about clearing per se; it's
13 about competition for execution in interest rate
14 swaps and CDS.

15 And allow me to make one other point.
16 The problem with the clearinghouse is not when
17 your smallest clearing member fails. The problem
18 with the clearinghouse is when your highly
19 interconnected, large, same guys are in the room
20 and the top three of them go. That's when you
21 have a problem with the clearinghouse. So, the
22 notion somehow that you should restrict

1 arbitrarily membership to a clearinghouse such
2 that you have more connected, larger, systemically
3 important institutions who are highly correlated
4 is patently wrong.

5 And I would also say, in specific
6 response to the question before about a specific
7 example, single-name CDS is a good example about
8 how something that could be cleared and should be
9 cleared could be viewed in an overly complex way
10 such that somehow it would be precluded, and I
11 think one of the main reasons that we passed the
12 Dodd-Frank Act was to deal with risk in the CDS
13 market.

14 MR. HILL: Okay --

15 MR. KASTNER: And I'll conclude.

16 MR. HILL: Can I just address -- we have
17 started clearing single-name CDS, and I think
18 highlighting single- name CDS might be a useful
19 example for thinking about what can and can't be
20 cleared. Looking at it simplistically, we should
21 say, well, single-name CDS is standardized. It's
22 all the same, so we should clear all single-name

1 CDS. And this is the issue we struggle with from
2 a risk-management perspective. Single-name CDS on
3 a very liquid U.S. Corporation that trades, you
4 know, in the hundreds of millions every day --
5 true, that can be cleared, and it is starting to
6 be cleared, because it can be valued by multiple
7 market participants. Single-name CDS on a highly
8 illiquid Latin American sovereign, which is only
9 traded by two entities and only trades maybe once
10 a month in \$10 million clips -- they're both
11 single-name default swaps; they're both completely
12 standardized; one is extremely liquid and easy to
13 value; one is completely illiquid and extremely
14 difficult to value. The one that's liquid and
15 easy to value should be cleared. The one's that's
16 illiquid and can't be valued or very difficult to
17 value should not be cleared. They're both single
18 name CDS.

19 And so I think using -- you know, the
20 point of single-name CDS highlights the
21 risk-management issue here. It's easy for someone
22 to say, who doesn't trade the product, single-name

1 CDS should be cleared; it's the same; it's all
2 standard; let's clear it. You have to understand
3 the risk of each individual contract, be able to
4 value it, be able to trade it, and be able to set
5 margin levels for it to decide whether it can be
6 cleared. And that's critical. And if we don't
7 get this right, we're centralizing all this risk
8 in the clearinghouses. They will become the next
9 too big to fail, and we don't want to do that.
10 These have to be risk-managed correctly, and you
11 need clearing members who understand the risk.

12 So we, again, are for complete open
13 access to clearing membership in any clearinghouse
14 as long as you have the capital to support it and
15 as long as you have the risk-management tools to
16 evaluate the risk of the products that are being
17 cleared.

18 With that, we are absolutely for that
19 kind of open access. From our perspective, the
20 more clearing members that are in a clearinghouse
21 who understand the risk who want to neutralize the
22 risk, that is better for us. That takes risk away

1 from us.

2 MR. RADHAKRISHNAN: Okay, we've got to
3 go on to the next topic, so I don't mean to cut
4 off the discussion, but we've got an aggressive
5 time schedule, so we want to make sure that all
6 the topics get discussed. But people are free to
7 send us their comments in writing, and I urge you
8 to do so and, you know, I think if you look at the
9 Federal Register at least, it will tell you how
10 you can send it in writing, but please do so.

11 So, now we're going to go on to swap
12 execution facilities, both security-based and
13 non-security-based -- and Cody.

14 MR. ALVAREZ: This is a non-dimension.
15 We're going to discuss swap execution facilities,
16 and specifically we'd like to again speak about
17 the conflicts of interest related to two points:
18 Permitting access and determining which swaps are
19 eligible for trading on the swap execution
20 facility.

21 MS. SCHNABEL: And I think we talked a
22 little about this previously. We're interested in

1 hearing more about vertical integration.

2 MS. SEIDEL: And also I would sort of,
3 in this discussion as well, when you're sort of
4 talking about conflicts of interest in the SEF or
5 the security-based SEF space, in light of the
6 structure of the Dodd-Frank Act where if a product
7 is cleared then it is traded to sort of speaking
8 of potential conflicts in light of the structure
9 put in place by the Act.

10 MS. SCHNABEL: We're going to go down
11 the line if no one volunteers.

12 MR. KASTNER: I'll take the ball for a
13 second with the SEFs.

14 The same principles that apply to DCOs
15 in terms of open access -- also if you carefully
16 apply to SEFs, anybody who is able to get a
17 clearing account at a qualified swap clearing
18 member or FCM to use the, you know, futures
19 analog, anybody that wants to trade on a SEF, the
20 SEF should not have any barriers to entry. So, in
21 other words, just like the futures markets, if
22 you've got enough money in your margin account to

1 go along with wheat because you have an opinion
2 about the Russian wheat harvest, similarly, if you
3 have an opinion about the direction of CDS or, you
4 know, an interest rate movement and you're
5 properly margined with a qualified swap clearing
6 member, you should have access. And, again, it's
7 about too big to fail and too interconnected to
8 fail. So, it's about bringing in greater
9 transparency and more participants in the market.

10 MR. OLESKY: I would agree with that. I
11 think I could speak from our own experience. We
12 have thousands of clients that are on our system,
13 and we have unbiased access rules that apply that
14 just set up certain standards that we need to have
15 as a business to maintain the integrity of our
16 business. So, I think there are, at a minimum,
17 certain standards that you need to have. They
18 should be impartial; they should be unbiased; and
19 they should be transparent. And there are, in
20 fact, for example, in our markets the Treasury
21 market, for example, which is not the subject of
22 this discussion, where we have standards for

1 liquidity providers to be primary dealers as
2 designated by the Fed. And the reason we have
3 those standards is that the thousands of
4 institutions that trade U.S. Treasuries around the
5 world when they come on to Tradeweb, they want to
6 know for certain that they're going to be able to
7 access the liquidity that is part of the
8 relationship that those primary dealers have with
9 those customers. So, at least on our system we're
10 open with out standards. We have over 40
11 liquidity providers around the world and several
12 thousand takers of liquidity, but we do have
13 certain access criteria that we apply that we're
14 transparent with in order to support the integrity
15 of the system and to continue, frankly, to have
16 clients come to our system to access liquidity and
17 use us as a commercial entity.

18 MR. HILL: We share the views expressed
19 that, you know, anyone who wants access to trading
20 should have access to a SEF. I mean, I think that
21 goes without saying. The more trading the better
22 as far as we're concerned. We also think there

1 should be multiple SEFs. We think the statute
2 allows the CFTC and the FTC to define SEFs, to
3 allow for different types of SEFs that act
4 differently and can be, you know, customized for
5 the types of users who want to use that SEF, so we
6 think that there should be multiple SEFs. There
7 should be multiple formats, you know, among those
8 SEFs, and whoever wants access to trading should
9 have access to trading. We don't think there
10 should be any barriers.

11 MR. SHORT: I think I'd just like to
12 point out some of the interconnected issues here,
13 and one thing we haven't really defined is what
14 exactly is a SEF, and I agree with most of what my
15 co-panelists have said about having proper access
16 to SEF, but I think with SEFs I think one thing
17 that has to be considered is what is a SEF and how
18 are these new forms of trading entities going to
19 discharge the core principles that they are
20 charged with discharging, and I think that in turn
21 feeds in to this question about which SEFs can
22 hook to the clearinghouse, so I think there are a

1 lot of questions that still need to be answered
2 before you can get to the conflicts question.

3 MR. DeLEON: This is Bill at PIMCO. You
4 know, that concept of using a SEF, I think it
5 should be free and open access. I agree with the
6 panel as well. The issue is that there needs to
7 be a guarantee that when you access a SEF, that
8 when you do a trade, that there is someone who is
9 guarantee that that is a good trade. So whether
10 that means that there's a market maker, sort of
11 someone to (inaudible) that facility, or if that
12 means that there's a DCM or an FCM or someone
13 who's going to guarantee that they're going to
14 stand behind force of unknown clients. As you see
15 in the current futures market, we can trade
16 anonymously and to a position that you go till
17 you're clear. We're a different -- need to know
18 that when you access or think there's a market
19 will work and you'll multiple SEF and the market
20 will behave quite well. If you have a situation
21 where when you pick up the phone, do an SEF, you
22 do a trade, you know which one to be a good trade

1 because there's going to be someone who ensured
2 that there's another side of the counterparty that
3 stands into it, and then there's a good, clean
4 mechanism to get that trade given up into a CCP
5 for clearing. And the market should work very
6 well, and you could have situations where there
7 are quite a few SEFs and a limited number of CCPs.

8 MR. COOK: There seems to be a consensus
9 that open access to a SEF is a good thing. I
10 think the issue we need to struggle with is how do
11 we make sure that happens and what are the
12 potential conflicts that we need to anticipate and
13 prevent in order to ensure that there is open
14 access, and going back to a statute again, we
15 meant to consider potential rules governing
16 ownership and voting and control of a SEF by
17 particular types of parties in order to ensure
18 that outcome. So, it would be helpful if we could
19 hear what should we be worried about here if our
20 goal is open access? What types of conflicts do
21 we need to try to anticipate and prevent against
22 happening? And are there differences in the types

1 of pressures that those particular parties
2 mentioned in the statutes while participants, bank
3 holding companies, et cetera, should we think of
4 them differently or are they all just one cup of
5 kind of just homogenous types of entities that we
6 should treat the same?

7 MR. KASTNER: Robert, let me try to
8 highlight a couple of the issues here which
9 address somewhat open access and ownership but
10 also one of the main issues. If you look at the
11 progress of the legislation into the final hours
12 was the notion that a SEF may operate by any means
13 of interstate commerce. A previous version of the
14 Bill required electronic trading, and so the issue
15 is can you trade swaps with two paper cups and a
16 string and carrier pigeons, or is it required that
17 they be on a screen, an electronic screen?

18 And another issue is should you have a
19 request for quote model or should you have a fully
20 disintermediated market where anybody can join any
21 bid and offer and anybody can participate in an
22 open way?

1 And I would draw your attention to page
2 345 of the Act where it discusses rule
3 construction, and it says the goal of the section
4 is to promote the trading of swaps on swap
5 execution facilities and to promote pre-trade
6 price transparency. Now, the only way that you
7 can have pre- trade price transparency is if it's
8 on a screen and everyone can see it ahead of time.
9 So, I think that's one of the main issues as you
10 are thinking about the definition of the SEF and
11 rule construction and electronic versus, you know,
12 carrier pigeon when you think about requests for
13 quote versus disintermediated market that you need
14 to consider.

15 MS. SLAVKIN: Another issue I think
16 arises in this context is the question of the
17 timeliness of information received by various
18 players in the market. I understand that the SEC
19 has probably been looking at the issue of
20 collocation with regard to the exchanges, and I
21 see this is a potential issue that could arise as
22 well in the context of the SEFs, and I think it's

1 important as you guys consider potential conflicts
2 of interest to also consider who's getting what
3 information, when they're receiving it, and what
4 they can do with that information once they
5 receive it.

6 MR. OLESKY: If I could just quickly hit
7 on the point Mr. Cook made -- or the question --
8 about conflicts of interest and how they relate to
9 ownership or governance, try and respond to what
10 you were -- part of your question.

11 I think it's really important to
12 recognize -- for all of us to recognize -- that
13 market participants really engender many market
14 facilities. And in my experience in the
15 investment of capital and the knowledge about a
16 particular space has led directly to innovations
17 and advances both with Tradeweb and another
18 company I was with, BrokerTech; exchanges;
19 clearing corps. If you go back in history, those
20 are the folks that have the capital to support
21 this innovation and the knowledge and experience
22 to move it forward. And while it's easy to sort

1 of be critical of that group, I think it's also
2 important not to cut off that flow of capital into
3 innovative organizations that are really groups of
4 market participants that are investing in these
5 types of mechanisms.

6 Tradeweb was started in 1997 with the
7 internet with a group of banks. We had four banks
8 initially. Then we sold 100 percent of the
9 company in 2004 and we weren't owned by any banks
10 for 4 years. Then we had another investment back
11 in, and we had a minority stake by some banks. I
12 think we really have to separate out the ownership
13 argument from the governance argument, because
14 it's critical to be able to access that capital
15 for entrepreneurs and for innovators when they're
16 trying to build these mechanisms.

17 MS. SCHNABEL: Darrell or Randy, I just
18 wanted to make sure that you had a chance to
19 participate.

20 MR. DUFFIE: Yeah, I wanted to go back
21 to this issue of open access. We talked earlier
22 about how the members of the clearinghouse should

1 determine what gets traded, and we also have
2 conflicts of interest arising from the incentives
3 of the dealers to profit from bid versus ask on
4 products that are not traded on swap execution
5 facilities. So the interaction effect here is
6 effectively if one gets cleared as one gets traded
7 on a swap execution facility, then we want to be
8 very careful that the members of a central
9 clearing counterparty that determine what gets
10 cleared and, therefore, have control over what
11 gets traded on swap execution facilities are the
12 members that have, you know, the right social
13 incentives to create competition. And, therefore,
14 I would like to revisit the point that Mr. Hill
15 made earlier that you need to be very, very large
16 in order to be a clearing member. This has this
17 interaction effect with creating competition.

18 If you -- I fully agree with Mr. Hill
19 about the clearinghouse in aggregate needs to have
20 the size -- capacity to wind down failing
21 positions.

22 MS. SCHNABEL: Oh, no, sorry. I don't

1 know exactly what happened, Darrell.

2 We're going to try to reestablish the
3 link to Darrell as soon as possible.

4 Maybe while we're waiting to reestablish
5 the link, maybe the panelists could sort of
6 expound on what he was saying, sort of in that
7 context of where there's a link between what gets
8 cleared and what gets traded and potential
9 conflicts with respect to the decisions as to what
10 gets traded or cleared?

11 MR. KASTNER: Well, I think where he was
12 going is the clearinghouse clearly has to be
13 stable enough, and there's got to be sufficient
14 capital, and there's got to be fair, publicly
15 disclosed, transparent requirements to become
16 clearing members. But where I hope he was going
17 before he got disconnected was to the point of
18 it's not if your smallest clearing member fails,
19 and it's about creating the right incentives where
20 there is sufficient diversity, and maybe the
21 number's not 5 billion -- maybe it's 500 million
22 or maybe it's 200 or whatever the right number is

1 -- but it's certainly not an arbitrary thing like
2 you've got to have a trillion dollars of swaps to
3 be a clearing member.

4 MR. BERNADO: I agree that there
5 shouldn't be arbitrary rules. The rules, again,
6 should be related to the ability to absorb losses
7 and the ability to manage risk, and, you know, I
8 think all the different CCPs that are out there
9 currently have different rules for this. And,
10 again, I think, you know, I would encourage you to
11 talk to the risk managers of each individual
12 clearinghouse either separately or as a group for
13 them to better articulate than probably any of us
14 have their concerns around clearing membership
15 criteria and what they think is the appropriate
16 level, because they're clearly independent of, you
17 know, any of us. And I think what you'll hear is
18 they think, again, that they need to be of
19 sufficient size and sufficient expertise, and
20 maybe the numbers -- 500 million, maybe it's 5
21 billion -- I have no idea, but the clearinghouse
22 risk managers are the best people to talk to about

1 that.

2 MR. OLESKY: Don't we really want to
3 create a model here that just creates an
4 environment for competition among business -- you
5 know, business models and business ideas, and I
6 think that this applies across the board to the
7 clearing corps., the SEFs, the exchanges. We want
8 an environment where there's competition. We've
9 heard it from different participants and different
10 perspectives -- competition among SEFs;
11 competition, frankly, among clearing corps.;
12 competition among exchanges; competition among
13 banks; competition among a broader group of banks.
14 I think that really should be -- you know, the
15 linchpin here is creating a set of principles and
16 regulations that allows for that competition.

17 MS. SCHNABEL: Okay, Darrell, you're
18 back on. I'm so sorry. Can you hear us?

19 MR. DUFFIE: Sure. Sure. I'm not sure
20 how much my point got across, but, again, 30
21 membership will eventually have some influence
22 over competition in the execution side of the

1 business, and therefore I want to revisit this
2 issue and that one must be a relatively large
3 player in order to participate in a clearinghouse.
4 Once one has the aggregate size necessary to wind
5 down failing positions, I want to understand why
6 additional 30 members that are not large would
7 reduce the ability of the clearinghouse to wind
8 down failing positions. And if that's not the
9 case, then perhaps wider access is important.

10 MR. LIDDEL: Hi, this is Liddel. To
11 answer that question, one of the things that we've
12 got to apply to all CCPs, Mike, if you look at
13 some of the waterfall structures that currently
14 exist, the way they are written, and if the
15 counterparty that just (inaudible) goes down,
16 depending on how catastrophic it is, the members
17 may not have sufficient capital to support, and
18 then the people using them as a clearer could
19 possibly be hit. So to the extent that they don't
20 have expertise and capital, by using a certain CCP
21 -- using a certain DCM through a CCP, you are
22 taking additional counterparty risk. So, it is

1 important to think about it from the standpoint
2 that there does have to be additional counterparty
3 and credit review there, because you are facing
4 both the Exchange as well as your clearing member.
5 And Jim can probably expand on that more
6 (inaudible) than I can. In addition, it's really
7 important to note that it sort of a conflict in
8 terms of what gets traded versus what gets cleared
9 and whether or not it makes sense to have either
10 those -- the people deciding what gets cleared,
11 what gets traded. At the end of the day, the
12 point about this is to reduce systemic risk to the
13 system and give people access to better
14 counterparty controls and have less credit risk.
15 We hope in that process this is viewed as a
16 utility, but, you know, competition should be --
17 while it's important should be secondary to
18 ensuring that the system does not become more
19 risky. And I think there have been several
20 examples outlined earlier today of things that
21 could be traded and could be cleared, but the
22 reality is there is no good risk management or

1 pricing for these things. There are certain CDS
2 that trade twice a month, 10 million (inaudible)
3 dealers. I'm not sure I want that on an exchange,
4 because someone could build a very large position
5 in that, and no one has a clue where or how to
6 trade that. And that is the type of thing that
7 costs them a lot of money for a certain system in
8 the program.

9 MR. HILL: I just wanted to go back to
10 what --

11 MR. KROSZNER: Okay, if I might jump in
12 here. It's Randy Kroszner. I think this is
13 getting in exactly the right issue about the role
14 of risk management, because we're now at by giving
15 very strong incentives to get things onto the
16 (inaudible) platforms making everyone
17 interconnected to the clearinghouse. So, in order
18 to avoid the kind of conference crises that we
19 saw, the clearinghouse has to be seen as very
20 strong, seen as basically bulletproof so that an
21 individual member going down won't cause the
22 cascading -- the sort of cascading concerns that

1 we saw in late 2008. And so it's crucial that
2 members have a very -- have the right incentives
3 for risk management. It may be difficult to have
4 two types of members on the exchange, but they
5 might have different incentives to get their
6 approaches to risk management, that you have
7 institutions that have very little capital,
8 because they might be willing to take more risks
9 and want the exchange to or take the central
10 clearer as well as the exchange to take more risks
11 than otherwise.

12 And a number of people said the point of
13 trying to migrate these things onto central clear
14 platforms and potentially on exchanges is try to
15 reduce those risks since you've got to think about
16 the incentives that people with different amounts
17 of capital might have for ensuring good risk
18 management. This has been -- but as I said
19 before, this is exactly the struggle since the
20 19th century that clearinghouses and exchanges
21 have had trying to get more things onto the
22 exchange, but also making sure that what is on the

1 exchange is something that can be -- that the
2 risks can be managed by the exchange or by the
3 clearinghouse.

4 MR. HILL: Just to expand on that point
5 for a minute, we've been focused very much on what
6 happens when a member defaults and you have to
7 sort of unwind the portfolio or inject more
8 capital into the clearinghouse. But the related
9 piece is who can inject risk into the
10 clearinghouse. So, the clearing members, in
11 addition to contributing capital to the
12 clearinghouse and margin, they interact with their
13 customers and put trades into the clearinghouse.
14 And because the FCM ultimately has a risk to its
15 customer, if its customer defaults, the FCM has to
16 carefully risk manage the amount of trades it
17 takes from any one customer and puts into the
18 clearinghouse. And so not only do you have to be
19 worried about someone's ability to fund the
20 clearinghouse in a default scenario, but you have
21 to be concerned that and focused on their ability
22 to risk manage their customer relationships so

1 that they don't put trades into the clearinghouse
2 that could otherwise destabilize the
3 clearinghouse. So, it's not just a wind- down
4 that you have to be concerned about; it's the
5 injection of risk into the clearinghouse as well.

6 MR. RADHAKRISHNAN: Jonathan, I think
7 you wanted to make a point.

8 MR. SHORT: I wanted to echo some of the
9 points made earlier, and I'd also just note that I
10 think if you'd get the governance of the
11 clearinghouse right, a lot of these problems will
12 go away, and I know that's the topic of the next
13 panel. But I would just like to go back and
14 reiterate that risk management here is paramount.
15 The reason there is a mandate for clearing in
16 Dodd-Frank is to make the financial system more
17 stable, and I realize there are conflicts that
18 have to be dealt with, but I have never heard the
19 Dodd-Frank Act described as, you know, an act that
20 was aimed at, you know, simply promoting
21 competition among financial institutions. That
22 really wasn't the gist of what we were doing here,

1 and, you know, while all of these things need to
2 be considered and balanced, I want to reiterate
3 that if you create a system that allows too much
4 risk or unmanageable risk to come into the
5 clearinghouse, we're going to be right back in
6 front of Congress again with hearings and major
7 problems, and that is the paramount thing that I
8 think people should take away from this when
9 they're looking at these questions.

10 MR. RADHAKRISHNAN: Now, I'd like to ask
11 a question, which I expand upon what Darrell said,
12 which I think is a good segue to our next area,
13 which is I think it's sad to say that apart from
14 the mandate to clear as many OTC instruments as
15 possible, the other mandate is to bring
16 transparency to these products through the listing
17 of them on exchanges and swaps execution
18 facilities. And I think, if I might pick on
19 Darrell's point, and the point is -- and correct
20 me if I'm wrong -- it's entirely possible that by
21 not clearing a large group of swaps, there will be
22 no trading requirement, because, one, if you -- at

1 least from the CFTC, you know, part of the world
2 -- you're dependent on DCO submitting swaps to be
3 cleared and then, you know, there's a comment
4 process and so on. And, two, the Commission on
5 its own has to make a determination as to whether
6 a group of swaps has to be cleared. But if the
7 Commission makes a determination that said this
8 class of swaps has to be cleared but nobody wants
9 to clear it, and let's say nobody wants to clear
10 it for, you know, nefarious purposes, then, one,
11 it won't be cleared; two, it won't be traded. So,
12 how do we make sure that the governance structures
13 -- how do we make sure that we take care of the
14 conflicts of interest to make sure that, you know,
15 what I consider to be the mandate of Congress is
16 not somehow blocked?

17 MR. KASTNER: This is the -- this goes
18 directly to this Lynch Light section 726. The
19 idea is I agree with you a hundred percent that we
20 could run the risk here if we don't manage the
21 governance properly where certain DCOs just sort
22 of refuse to engage. Now, certain things -- I

1 mean, it would be very difficult to say that a,
2 you know, plain vanilla interest rate swap is
3 somehow unclearable. I mean, people have tried to
4 say it before. You know, ooh, it's so
5 complicated, it could be annual money; it could
6 be, you know, actual 360 or whatever. But I don't
7 really see that as a risk. I think that the issue
8 is making sure that the risk committees of these
9 DCOs are transparent, that you know who the
10 membership is, that the decisions that are taken
11 about whether to permit new clearing members and
12 whether to permit new products to be listed are
13 transparent and readily appraisable, and so that
14 everyone knows, you know, what's going on so you
15 can -- I think the word you said was "nefarious."
16 You know, you want to make sure that things are
17 being done in the public interest to protect the
18 American public against another financial
19 calamity, not to preclude for some, you know,
20 bizarre reason a product going on or a new
21 clearing member, and that applies. So,
22 transparency -- it not only applies in prices of

1 securities and security-based swaps and
2 everything; it also applies in governance. So,
3 this is an open hearing, right? There's a public
4 record. There's cameras. There's recordings.
5 The same type of transparency should apply to DCO
6 governance so that everyone is clear about how
7 decisions are taken and how they're made and who's
8 making them.

9 MR. SHORT: I agree with what Jason just
10 said. I think if you get the governance right, a
11 lot of this goes away, and I think there should be
12 an open dialog with the regulator, independence on
13 board so that you don't face this situation where,
14 you know, for a nefarious purpose things are kept
15 out of clearing. But, you know, I would note that
16 there is a financial incentive on the part of most
17 clearinghouses to clear clearable swaps. It's in
18 our interest to do that, so I think, you know, if
19 you get the governance right, a lot of this -- a
20 lot of the rest of it should fall into place.

21 MR. HILL: I would like to echo that we
22 agree with both those points and also want to add

1 -- remember that in most -- I think most if not
2 all of the different product areas there are
3 multiple clearinghouses competing with each other.
4 So, and credit in the U.S., you have ICE and CME
5 and others, and rates, you have LCH and CME and
6 others, and these are all profit-making
7 institutions and, you know, they're going to
8 balance their desire to make money and clear as
9 much as possible with their own internal
10 risk-management concerns about what should be
11 cleared and not be cleared, and I think that
12 competition will go along toward making sure the
13 right balance is struck.

14 MS. SCHNABEL: Darrell, I just wanted to
15 make sure that you had a chance to speak again.

16 MR. DUFFIE: I agree with those points
17 that have just been made.

18 MS. SLAVKIN: I just wanted to --

19 MS. SCHNABEL: Sorry, Heather, please.

20 MS. SLAVKIN: Sure. I just wanted to
21 add on, on the governance issue, that I do think
22 it's important in addition though to transparency

1 and independence I think having real experts on
2 the boards of directors is a very important issue.
3 We all saw situations in the last several years
4 where there were boards that were two-thirds
5 independent and made really stupid decisions about
6 risk management. So, we need to make sure that
7 there are people on those boards of directors that
8 really understand the risks that exist within a
9 clearinghouse and are prepared to perceive
10 potential risks that may arise in the system down
11 the road and address them. So they also need to
12 have the personalities to stand up to a board of
13 directors that may be entrenched and have their
14 own interests that may differ from those that are
15 in the best interests of the systemic stability.

16 MR. SHORT: I want to just add something
17 to what Heather said. I mean, she's right, but I
18 just want to point out that there really is a
19 tension there, because some of the people who are
20 best qualified to assess risk in a given market
21 are the people that some parts of the -- you know,
22 of the market are complaining about is controlling

1 clearinghouses and controlling key infrastructure.
2 That's just the fact, and not saying that they're
3 the only people that can do it, but I think when
4 we're assessing good governance and who should sit
5 on boards, who should sit on risk committees, the
6 idea of excluding the very people that have the
7 most visibility into the market is not a very wise
8 decision from a risk-management perspective.

9 MR. NAVIN: I would second those
10 remarks. Our experience has been that we've
11 benefited greatly from the expertise of industry
12 directors, and I think it would be throwing the
13 baby out with the bathwater if substantial
14 restrictions on industry governance were to be
15 enacted.

16 MR. ALVAREZ: Excuse me, I have a
17 question. How -- we kind of have conflicting
18 points here. We need enough independence by
19 having enough public directors, but we also need
20 to preserve the expertise, so how are we to strike
21 that balance?

22 MR. KROSZNER: This is Randy Kroszner.

1 If I might, I think this gets back to the
2 transparency point, but I do think it's extremely
3 important to have people with the knowledge, the
4 wherewithal, and with their money on the line
5 having input into these risk-management decisions,
6 and I think the best way to ensure that is to
7 ensure a very, very transparent process so that
8 outsiders can evaluate and provide the commentary
9 and the independent directors will have enough
10 wherewithal, enough knowledge to know what is
11 going on. And also what I think could be very
12 valuable in these prophecies is not just to make
13 them transparent so that you can see how the
14 decision is made, exposed on an individual
15 contract, but something that could very valuable
16 is for principles to be outlined in advance of
17 what types of contracts can come onto exchanges,
18 how the decision process will be made. Because
19 one of the things that we're trying to accomplish
20 with Dodd-Frank is a migration of some of these
21 contracts onto essentially bigger platforms.
22 Providing a roadmap for how to do that will help

1 to encourage market participants to restructure
2 contracts to make them in a way that -- or write
3 them in a way that will be more readily clearable.
4 And so I think you get a double win on that of
5 bringing more over-the-counter types of contracts
6 onto exchanges and you'll have a much a
7 transparent process. Because I think it's good to
8 have the process transparent not only ex poste
9 after the decision is made, but also ex ante what
10 kind of principles they used and how the decision
11 will be examined or how the decision will be made.

12 MR. DeLEON: This is Bill at PIMCO. I
13 just want to point out that there is quite a bit
14 of transparency already, and there's a second
15 check on the risk-management process that any DCO
16 will use, which is that end users will decide
17 whether or not (inaudible). And if there is sort
18 of a race to the bottom in terms of not charging
19 sufficient capital or having good risk management,
20 end users will not want to use that DCO for
21 clearing. So, you will naturally see and move
22 away from them, and if you look at the current

1 models that are employed by the exchanges, they
2 tend to be conservative, and it's pretty easy to
3 be transparent when they change margins, because
4 you need statements from them saying they've gone
5 up or they've gone down and you need to post right
6 away. So, I think that process already is in
7 place and works, and at the end of the day as
8 there are more DCOs, end users will make a very
9 loud vote with their feet in terms of where they
10 put their capital, because if someone's charging a
11 lower rate or has very low margin, you know, at
12 the end of the day people who have fiduciary
13 responsibilities to manage clients' money will
14 have to go well, it may be cheaper but it's not
15 going to provide the protections I need; I don't
16 think I want to use them. So, I think there is a
17 natural mechanism in the market to enforce that.

18 MR. RADHAKRISHNAN: We need to move on
19 to exchanges -- to contract markets and national
20 security exchanges, so --

21 MR. WORKIE: Can I just ask one more
22 question? It's going to relate to all the points,

1 and then, Shawn, if I could (inaudible) I tried to
2 get in a couple of times today.

3 You know, a lot of questions, a lot of
4 the discussion I've heard is related to complex as
5 it relates to kind of members of the clearing
6 origination or potentially members of the SEFs.
7 Are there any financial institutions that are not
8 members, because the Dodd-Frank doesn't spell it
9 out between members and non-members. It just
10 lists financial institutions. So, with respect to
11 the group that's non-members and are financial
12 institutions, are there conflicts with respect to
13 those that we should be considering, or is that
14 really just tied into those that are actually
15 members?

16 MR. BERNADO: Well, what I wanted to say
17 was, just to go back to the original definition of
18 "SEF," it says "trading"; it doesn't say "trading
19 facility." And to go back to what Jason mentioned
20 about any means of interstate commerce, there are
21 multiple modes of interstate -- of -- I think what
22 was intended was there are multiple modes of

1 execution in what we do -- voice, electronic, and
2 hybrid. It really depends upon the product. The
3 more liquid products, like Lee said, in U.S.
4 Treasuries, it's highly liquid, it's very
5 efficient, it trades fully electronic on screen,
6 but some of the less liquid products don't -- they
7 need voice intervention. They need to provide
8 that liquidity to the marketplace, and to keep the
9 markets moving you need to have voice -- you need
10 to have the multiple modes of execution that was
11 mentioned before in regards to interstate
12 commerce. I don't think that answers the question
13 that you just asked.

14 As far as institutions or different
15 types of institutions, we're open to having
16 multiple participants on platforms, which we
17 currently do.

18 MR. KASTNER: If I could try to answer
19 your question directly in terms of other conflicts
20 of interest, apart from clearing members, okay,
21 it's about access to clearing, so there are -- the
22 membership of the Swaps and Derivatives Market

1 Association. There are over 20 firms who would
2 love to get into the business of trading interest
3 rates, swaps, and CDS with our customers who, by
4 historical accident, credit rating, or for
5 whatever reason have not developed that capability
6 and who need access to clearing. So, it's not
7 just about becoming a clearing member of an
8 exchange and who gets to be a clearing member.
9 It's about who can open a clearing account with a
10 FCM, SCM, whatever, and the point is if you have a
11 firm who is doing customer business and wants to
12 engage in an interest rate swap with an end user
13 who is not a clearing member, that they should be
14 able to execute that trade with the end user and
15 then give up to a clearing member. So, what it
16 does is it allows more participants to diversify
17 the risk. Some of them may not be big enough to
18 become swap clearing members of an exchange, but
19 they're certainly big enough to take the other
20 side of a \$100 million interest rate swap. Do you
21 see what I mean? And so that's one of the key
22 issues that goes back to this issue of opening the

1 market and bringing in more competitors. And so
2 that's something that I think that you really
3 should focus on in the rule-making stage.

4 MR. COOK: If -- taking -- just to build
5 on that point, if one's concerned about preserving
6 the access to membership, as you point out is a
7 central issue, and tie it back to Haimera's
8 question, does one take from that that your
9 primary concern is that the control over access is
10 with dealer members? And so if you have dealers
11 who are not members who may have an ownership
12 interest, you are indifferent to that but because
13 you really think that the conflict is between the
14 dealer members potentially restricting access by
15 non-dealer members, other types of financial
16 institutions who aren't members of the
17 clearinghouse, there's no conflict of interest?

18 MR. KASTNER: The problem isn't with,
19 you know, dealer members restricting customers
20 from being clearing members, right? They're more
21 than happy, you know, to, you know, use a name.
22 You know, PIMCO is a member of the panel. I'm

1 sure any number of investment banks would be more
2 than happy to open a clearing account for a
3 buy-side institution such as that. The issue is
4 if there is a sell- side institution that wants to
5 do a trade with PIMCO, just to use an example,
6 that isn't a clearing member, that requires access
7 to a big financially important clearing member's,
8 you know, capital base in order to facilitate that
9 transaction now, that other firm, that other
10 smaller, independent investment bank firm that
11 wants to do that trade -- we need to have a system
12 where they can do that, because what we don't want
13 is the same 10 guys holding all the risk and then
14 concentrating in the clearinghouse. The idea is,
15 you know, introduce more participants who have
16 access to clearing in order to facilitate that
17 business, and that's where there has, in the past,
18 been a bit of tension. I'm sure that given the
19 various anti-trust provisions in the Act, as well
20 as the ability of this Commission to issue
21 cease-and-desist orders, that these problems will
22 probably go away, but it's something that you need

1 to keep an eye on.

2 MR. BERNADO: And, again, having a
3 vertical -- having both the clearing and the
4 execution definitely creates a problem, because
5 there are so many means in which when you have the
6 execution facility and you're competing in our
7 space, which is what we do as SEFs, when you don't
8 allow our customers, who are also the customers of
9 the exchanges, to submit the trades the same exact
10 way or do certain things, they can definitely
11 create biases, which they currently do. I mean,
12 we experience that today in certain markets where
13 the exchange also has an execution platform that
14 competes with us, and we cannot submit our trades
15 to that clearinghouse the same way the exchanges'
16 customers, who are also our customers, executing
17 the same type of trades can submit to the
18 clearinghouse. So, that's without question a
19 conflict of interest that goes on today. It's a
20 major problem with having a variable.

21 MR. HILL: Right. We reiterate that
22 point that we think the clearinghouse should be

1 agnostic as to which SEF they accept trades from,
2 and the SEFs should be agnostic as to which
3 clearinghouse they send trades to. I'm sure that
4 would be a --

5 MR. OLESKY: Yeah, we do, and that
6 actually is our policy at Tradeweb. We actually
7 have that approach. I'll just echo the comments
8 that were just made. I think that there's also a
9 statement about equal access, and then there's the
10 reality of actually truly having equal access, and
11 that gets down to really connectivity, technology,
12 cooperation, cost differentials that are really
13 the nuts and bolts of how do you actually really
14 get equal access. So, as much as I think everyone
15 will agree that everyone should have equal access,
16 it really needs to be detailed so that there is
17 not a bias that's applied subtly, which can happen
18 and happens today when there's a -- and I
19 understand it, because there's a conflict.
20 There's a conflict where we will be competing with
21 a part of a clearing partner. So, there's a
22 built-in conflict there.

1 MR. ALVAREZ: Yep. Moving away from SES
2 for a moment, talking about DCMs now, what are the
3 similar types of conflicts that you're going to
4 see with DCMs as clearing swaps?

5 MS. SEIDEL: And I echo that question
6 with respect to exchanges as well, sort of the
7 existing trading markets versus the new ones that
8 the Act puts in place. Are there any similarities
9 or differences and concerns about conflicts with
10 respect to trading?

11 MR. HILL: I think the exchanges
12 currently -- I think most if not all have this
13 vertical model where if you trade on an exchange,
14 you have to clear it through their clearinghouse,
15 and I think the rules that apply to SEFs should
16 apply to exchanges as well. It should be open
17 access.

18 MR. KASTNER: Let me give you a specific
19 example. One of the members of this SDMA
20 currently clears 13 percent of the business at a
21 large exchange in Chicago. That large,
22 independent FCM is clearly qualified to become a

1 swap clearing member. But because of various
2 conflicts of interest, the risk committee of said
3 exchange is precluding that firm, which is clearly
4 qualified and has the capital, from becoming a
5 swap clearing member. They're more than happy to
6 let -- you know, they remain an FCM in good
7 standing, but in terms of branching out and
8 entering into these new products, a very motivated
9 firm which wants to open clearing accounts for our
10 members is currently being effectively shut out,
11 and those are the types of things where -- this
12 goes back to the governance point and transparency
13 about who's making that decision and why, because
14 a lot of times what happens is people will swallow
15 themselves in the cloak of risk management or
16 financial stability or whatever really to make an
17 anti-competitive stand. In other words, you can
18 never say that you don't want to let somebody in.
19 But you could probably find an excuse or a reason
20 in the interest of systematic -- you know,
21 systemic stability and the rest of it to put an
22 asterisk on the application or just delay it for

1 awhile. So, those are the types of issues I think
2 that we need to be looking at.

3 MR. RADHAKRISHNAN: So, let me follow up
4 on that. Let's say, for example, you had a
5 clearing organization exchange would say in order
6 to be a clearing member you must have capital --
7 regulatory capital of a billion dollars, let's
8 just say, as calculated in accordance to SEC-CFTC
9 rules. So we know that it's what I consider true
10 \$1 million -- safe \$1 billion. And let's say
11 somebody comes to us and says you know what, we
12 think that's unfair; we want you to lower -- we
13 want you to cause the clearinghouse to lower the
14 capital requirement. So, by somebody in charge of
15 clearing, I'm kind of reluctant to tell somebody I
16 think you need to lower the capital requirement.
17 Well, unless you give me very good reasons.

18 What are those reasons? What would
19 cause either Robert or I to go to a clearinghouse
20 and say, you know, I think you need to lower the
21 capital requirement?

22 MR. KASTNER: So, it's not only about

1 the capital requirement. I agree that not only
2 would it be imprudent to have requirements that
3 are too low, but that also in terms of what the
4 American public's perception would be of a
5 regulator who's going around telling exchanges to
6 lower their capital requirements after we just had
7 a huge blowup. I mean, that's a big ask, right?
8 But it's not just about capital, which needs to be
9 set at a fair level. It's about -- if you get in
10 these discussions -- let's say, for example, you
11 have a firm that has the billion dollars of
12 capital. They'll make some arguments, some
13 operational expertise argument, and again it goes
14 back to this chicken and the egg things. Well,
15 you don't -- you've never cleared swaps before, so
16 you can't clear swaps. You see? Or let me give
17 you another solution. You permit a joint venture
18 between a large money center bank, which has a ton
19 of capital, but relatively meager operational
20 expertise. And FCM that is very strong in
21 operational management; a SEF that can provide the
22 necessary pricing information and assist in a

1 default management procedure. So, it's not just
2 about, you know, drawing a line in the sand and
3 making that bar higher and lower. It's about
4 being clever about how we actually look at risk
5 and manage risk and how do you actually come up --
6 what is the right number, you know?

7 What is the sigma of an earthquake in
8 San Francisco, you know? I mean, what is the
9 answer to that question? Is it --if I had a
10 billion and one dollars I can trade as many as I
11 want, but if I only have 200 I can't trade any?
12 The point is there's position limits, right? And
13 the amount of risk that you introduce is
14 proportional to the amount of capital that you
15 have, that you're clever about managing the
16 margin, that you're clever about managing your
17 risk, that you're a savvy trader, and that a guy
18 with, you know, 500 million in capital can't clear
19 as many interest rate swaps as a guy with 5j
20 bazillion, but that he can clear some, that it's
21 somehow proportional. So, the CFTC does not have
22 to go and say to the exchange you must lower your

1 barrier to entry. What you should do is say you
2 must make trading ability and clearing ability
3 proportional to the capital that you have.

4 MS. MOORE: You know, are these issues
5 unique to the swap and security-based swap market?
6 Because we do have member-controlled institutions
7 today that act as utilities and provide for open
8 access. So, you know, I just wanted to know how
9 the conflict of interest issues, you know, are
10 viewed with respect to the swap in the current
11 markets today.

12 MR. HILL: I think the conflict issues
13 are similar. I think the risk management aspect
14 of this, though, is certainly more heightened with
15 respect to OTC derivatives even once they're
16 traded on SEF, for example, than they are for the
17 sort of highly, highly liquid exchange rate of
18 products that you might see in the future as well
19 during the -- or, you know, in the stock
20 exchanges, and that's simply because by definition
21 these products are less liquid; they're more
22 complex. And so the skill level in risk managing

1 them, or the expertise level in risk managing them
2 is higher, and I think your sensitivity around --
3 or the clearinghouse's sensitivity around ensuring
4 the right to participate is probably heightened.
5 And I think that's just a function of complexity
6 and liquidity.

7 MR. SHORT: I want to add to that -- I
8 think your question is are there differences
9 between the existing derivatives markets and the
10 equity-based derivatives markets, and if that was
11 your question I think they have come from very
12 different places and, you know, one of the things
13 that I struggle with is, you know, it all sounds
14 very good on paper to say let a thousand flowers
15 bloom, we'll have hundreds of SEFs. They'll all
16 hooked to a clearinghouse and everything will be
17 great. We've got competition, but there are some
18 very real issues that I think are going to be very
19 difficult to work out in terms of how the DCO
20 discharges its regulatory obligations. We've got
21 an Act that talks about having position limits
22 apply across markets, across venues.

1 You know, there are a lot of questions
2 that I think we haven't even begun to get into
3 here that may impact the ability of a particular
4 SEF, for example, to hook to a derivatives market.
5 And I know I've heard a lot of people hold the
6 equities market up as an example of how you have
7 multiple execution venues and everything is great.
8 I don't think everything is so great. I mean,
9 we've had flash crashers; we've had problems.
10 You're talking about -- and when you're -- I just
11 want to emphasize this point. When you're talking
12 about risk managing derivatives in our world,
13 you're talking about managing risk over a very
14 long time horizon. And clearing of these
15 derivatives is very complex, so I'm not saying
16 that this is something that should preclude open
17 access. But I think we need to go into this very
18 carefully, and I think we need to consider how all
19 of this actually bolts together in the real world
20 and allows the markets to be properly regulated,
21 because I think there are a lot of regulatory
22 objectives here that we haven't talked about.

1 MS. SCHNABEL: Heather. Heather, I
2 thought you wanted to say something. Did you --

3 MS. SLAVKIN: I was just going to
4 further expound, I guess, on the point that Jason
5 was making earlier about the importance of not
6 allowing the argument that we're having right now
7 about the need for capital requirements to become
8 a bar to entry for smaller players. And this
9 issue really echoes issues that arose in the
10 debate around capital requirements for the large
11 financial institutions that occurred in the
12 process of developing the Financial Reform Bill.
13 And one of the big issues that people were talking
14 about was whether progressive capital requirements
15 were the way to go, because, you know, saying --
16 you know, if you look at the 5 largest financial
17 institutions that control 90 percent of the market
18 and say that's going to be the bar for how much
19 capital you have to have, the amount of risk and
20 the amount of activity that those institutions are
21 engaging in is not the same as the amount of risk
22 and the level of activity of the smaller players

1 in the market, so it doesn't make sense to hold
2 them to that high standard. And I think it would
3 be important here to try to consider the
4 possibility of creating requirements, have
5 progressive capital requirements that consider
6 volume and size and activity and risk when you're
7 determining what the appropriate capital
8 requirement should be for gaining access to a
9 market.

10 MR. KASTNER: And I would also direct
11 your attention to the antitrust provisions where
12 the Commission has been directed that unless
13 necessary or appropriate to achieve the purposes
14 of the Act, you shall not adopt any process or
15 take any action that results in an unreasonable
16 restraint of trade or impose any material,
17 anti-competitive burden on trading or clearing.
18 So, unless you've got a really good reason to have
19 a trust or a monopoly or some, you know, closed
20 system, there is a clear directive here and
21 there's clear remedies as well. So, I think that
22 as you think about it, and as you think about risk

1 management, you have to balance those risk
2 management arguments against various other clear
3 calls for a lack of anti-competitive behavior.

4 MS. SCHNABEL: Okay, I think that we're
5 counting down to the end of the first panel, so I
6 just wanted to throw kind of a general observation
7 out there.

8 It seems as if one of the themes of our
9 conversation is we need to figure out how to not
10 inject systemic risk in clearing and listing of
11 swaps, but then we also have to balance that
12 against the systemic risk that would exist if
13 bilateral swaps are not cleared or listed because
14 of certain incentives. And so I guess I would
15 just welcome the panelists to give their final
16 thoughts on this subject on how the balance can be
17 achieved.

18 MR. RADHAKRISHNAN: Let's go down the
19 lines.

20 MR. SHORT: I would just say that -- one
21 other observation -- I don't think this is going
22 to occur in a vacuum. My understanding of what

1 happens under Dodd-Frank is that for swaps that
2 are not cleared, there are prudential regulators
3 who will be looking at the capital that has to be
4 held by a given bank or market participants, so I
5 think there are going to be other levers that are
6 pulled that move things towards clearing.

7 MR. NAVIN: I think it's very important
8 that the risk managers be left to manage the risk,
9 and I think that there may be situations where
10 they have conflicts of interest. There may be
11 situations where in fact they're being
12 exclusionary. And I think in those situations
13 we've got to rely on complaints by the people that
14 are being adversely affected to the regulators and
15 on appropriate response by the regulators. I
16 don't think they can close their eyes to
17 restraints of trade. But I think a regulator has
18 to be very careful in second guessing experience
19 to risk managers.

20 MR. OLESKY: That's pretty much what I
21 was going to say, Bill. You know, this is a
22 really tough thing to balance. We do this all the

1 time, and for us it's about the integrity of our
2 platform, the integrity of our system, and so what
3 do we do when we make a decision to get into a new
4 product line, a new business? We started trading
5 derivatives in 2005 -- interest rate swaps. What
6 do we do? We listen to the market participants,
7 which is what we're doing right now, and I think
8 really try and figure out, okay, what can
9 legitimately work here, what will be the right
10 balance between, you know, getting the risk into a
11 clearing corp. and having standardized enough
12 things, traded electronically, traded over voice
13 through a SEF versus pushing things beyond what is
14 really going to work in the marketplace, and so I
15 think it's this balancing act. It's a challenge,
16 but I think it's this process that we're going
17 through of kind of engaging with the market
18 participants that'll get us closer to the answers.

19 MR. HILL: I would probably reiterate
20 what Bill said, which is that ultimately the risk
21 managers of the clearinghouse are the ones who
22 need to figure out how to manage these risks and

1 manage these conflicts, and as I said a few times
2 earlier I would certainly encourage the CFTC and
3 the SEC to reach out to those risk managers to get
4 their direct views on how these risks and these
5 conflicts are best managed. I think getting a
6 cross section of the market to opine is useful,
7 but ultimately we have to get this right. The
8 primary purpose of Dodd-Frank was to reduce
9 systemic risk. That risk will now be concentrated
10 primarily in the clearing houses, and it is
11 critical that we get the risk management correct.

12 MR. KASTNER: I would close by referring
13 to Chairman Gensler's comments on July 15th when
14 he commented on the passage. The essential point
15 is that we have open platforms that are
16 transparent to protect the American public. So,
17 we have to act in good faith. We have to have
18 openness and transparency.

19 MS. SLAVKIN: And I think the question
20 you asked echoes the question that the people who
21 are drafting this legislation were asking that
22 took them several hundred pages of legislative

1 text and almost a hundred rulemakings for you guys
2 to try to figure out the answers to, and I think
3 that, you know, conversations like this with
4 market participants at the beginning of the
5 process of determining what that right balance is,
6 and I agree it's going to take, you know, the risk
7 management staff at the clearinghouses as well as
8 diligent oversight by the regulators.

9 MR. BERNADO: I think that -- I keep
10 hearing people say "listed," and I think the
11 listed implies that you're looking to push things
12 on to exchanges or it implies that, and currently
13 -- I mean, we as the WMBA, the interdealer broker
14 market, already operates efficient markets. And
15 to go back to multiple -- to interstate commerce,
16 there are definitely multiple modes of execution
17 that need to stay in place to keep these modes
18 sufficient, keep them like good, and not to upset
19 the flow of the markets currently. So, you need
20 voice; you need electronic. Certain things will
21 be pushed to get standardized and get pushed to
22 exchanges. But, again, we keep saying "listed."

1 That's not -- it's definitely a concern. We don't
2 want to upset the markets as they currently are,
3 because we play an integral part of keeping them
4 as efficient as they are currently.

5 MR. RADHAKRISHNAN: Okay, we'll go to
6 Darrell on the video and then Bill DeLeon and
7 Randy Kroszner on the phone.

8 MR. DUFFIE: Thanks. I think the most
9 important principles here are incentives. I don't
10 think there's a conflict between the incentives
11 for competition, increasing competition in this
12 market on the one hand and the incentives for
13 improving financial stability on the other, or I
14 don't think there's a problem between those two.
15 You can have going to have both. The incentives
16 to watch for on competition are that we've got
17 enough access by multiple market of participants,
18 and that the oligopolistic nature of the market
19 is, to some extent, watched carefully by
20 regulators. And on the systemic list side I think
21 the incentive issue is that everyone benefits from
22 the safer markets, but not everyone internalizes

1 the costs and benefits on their own, and,
2 therefore, regulators need to look for those
3 weaknesses in financial stability for which no one
4 individually gets the benefits. And, in this
5 case, clearing and a relevantly transparent system
6 are going to move in the right direction.

7 MR. RADHAKRISHNAN: Bill?

8 MR. DeLEON: Thank you. Yeah, I agree.
9 I think that the most important thing to focus on
10 is that it's meant as a reduction in systemic risk
11 as a utility function, which does not preclude,
12 you know, people having access, but you need to
13 set a bar. It shouldn't be arbitrary and it
14 should be fair. I agree that more participants in
15 the clearing space, as long as they meet some bar
16 and it's not a capricious or, you know, sort of
17 exclusionary, will reduce risk to a system and
18 ultimately bring cost down and tells the system.
19 But at the end of the day, you do need to listen
20 to who's doing the risk management. And I think
21 you want to talk to both the current people as
22 well as, you know, other risk managers throughout

1 the industry and see what they think is
2 appropriate to come up with what that bar should
3 be and how it should function. But rushing to
4 force things on the CCPs with too low of a bar
5 will not accomplish what we're looking for.

6 MR. RADHAKRISHNAN: Randy.

7 MR. KROZNER: I certainly echo those
8 last two sets of comments. The success of
9 clearinghouses and the reason why there's been so
10 much push to try to get many contracts into
11 centrally (inaudible) platforms is precisely
12 because of their success over a century in
13 managing risks. They've been very successful
14 through World War I, World War II, the Great
15 Depression, and we should not do anything that is
16 going to undermine that by forcing things that
17 will -- or forcing types of contracts that cannot
18 be risk managed well onto the Exchanges to --
19 forcing certain -- using certain criteria that
20 will undermine that risk management. The success
21 has come from being tough about risk management,
22 but sometimes means setting very tough criteria

1 that some institutions and individuals may not
2 like. But we're now basically betting the system
3 on the stability of these clearinghouses. And if
4 we're going to do that we've got to make sure that
5 they're not going to undermine the stability, but
6 they're going to be seen as bulletproof or as near
7 to bulletproof as any private institution can be.

8 MR. RADHAKRISHNAN: Well, thank you.
9 With that, we come to the end of the discussion
10 for today, for right now, on Panel 1.

11 I would like to thank the panel for a
12 very spirited discussion. I think it's very
13 obvious that you'd given a lot of thought to the
14 subject, and on behalf of the staff the CFTC are
15 very grateful for your time and your thoughts.
16 So, thank you very much.

17 We'll just spend a few minutes swapping
18 out and invite the members of Panel 2 to come up,
19 but thank you.

20 Thank you very much.

21 (Recess)

22 MR. RADHAKRISHNAN: Start Panel 2, which

1 is Possible Methods for Remediating Conflicts.
2 The topics will be, one, ownership and voting
3 limits; two, structural governance arrangements;
4 three, substantive requirements; and number four,
5 the appropriateness of applying the same methods
6 to each type of entity.

7 I'm going to ask each of the panel
8 members to introduce themselves and then we'll
9 have questions.

10 MR. BARNUM: I'm Jeremy Barnum from J.P.
11 Morgan.

12 MR. SCOTT: Hal Scott from Harvard Law
13 School. I just want to give a disclaimer that I'm
14 also the director of the Committee on Capital
15 Markets Regulation, but I'm not speaking for the
16 committee at this session.

17 MR. GREENBERGER: Michael Greenberger,
18 University of Maryland, School of Law.

19 MR. PRAGER: Richie Prager from
20 Blackrock.

21 MR. LIDDEL: Roger Liddel from London
22 Clearing House.

1 MS. MARTIN: Lynn Martin from NYSE Life,
2 U.S.

3 MR. KASTNER: Jason Kastner, Swaps and
4 Derivatives Market Association.

5 MR. McVEY: Rick McVey, MarketAxess.

6 MR. BERNARDO: Shawn Bernado, WMBA.

7 MS. SLAVKIN: Heather Slavkin, AFL-CIO.

8 MR. RADHAKRISHNAN: Thank you. Andrea?

9 MS. MUSALEM: Okay, so we spent the last
10 two hours talking about the conflicts -- the
11 potential conflicts of interest and now we turn to
12 the possible methods of remediating those
13 conflicts. The first topic is ownership and
14 voting limits and the first question is: Would an
15 ownership cap mitigate the actual or potential
16 conflicts of interest identified in the previous
17 two hours?

18 MS. SCHNABEL: Go ahead, Hal.

19 MR. SCOTT: I should say -- while I'm
20 not speaking for the committee, the one thing the
21 committee did say on this is that they opposed
22 ownership restrictions, so I think I can speak for

1 the committee on that, the reason being that I
2 think they're counterproductive in getting needed
3 capital liquidity into the clearinghouses which, I
4 think, should be our central focus in terms of
5 systemic risk.

6 In my view the potential conflicts
7 should be generally handled by board governance
8 rules and not by ownership restrictions.

9 MR. GREENBERGER: Yeah, I feel exactly
10 the opposite. First of all, what disturbed me
11 about the first panel is talking about this in an
12 isolated and not contextual viewpoint. The
13 problem here, the origination for the Lynch
14 amendment, which put a 20 percent cap on ownership
15 was a concern that then existing clearinghouses
16 were setting their requirements for membership
17 unreasonably high, in a manner that was
18 discriminatory.

19 It is true that the central tenant of
20 the statute is to require clearing and exchange
21 trading. If you have one clearinghouse dominated
22 by the major swaps dealers, they have several

1 conflicting incentives. One is, I reject the idea
2 that somehow they do not want to keep a large and
3 vibrant over-the-counter market. We're told that
4 clearing is very profitable. If it was that
5 profitable, where were these people when we were
6 aggressively arguing for mandatory clearing and
7 exchange trading? They were on the opposite side
8 of that. The transaction fees and the spreads
9 still make an unregulated market very, very
10 profitable, probably more profitable than the
11 profits that would derive from clearing. So, if
12 you have the swaps dealers in control of a
13 clearing facility, they have that incentive.

14 Secondly, if they set their membership
15 so high, they are going to sift away the strongest
16 members of the swaps market and the other clearing
17 facilities are going to be left with everyone
18 else. That does not -- first of all, it's not
19 open and fair access and it will create systemic
20 risk in the other clearing facilities who have to
21 take the leftovers from these clearing
22 organizations.

1 Secondly, the argument that, for
2 example, ICE Trust, which has nine banks taking 50
3 percent of the profits, are the best judges of
4 risk management, is belied by the credit crisis we
5 went through in 2008. It was these very banks
6 that caused the crisis because their risk
7 management policies were so weak, and to
8 centralize the too big to fail banks, and they are
9 called too big to fail because there is a
10 recognition that if they fail they will be
11 rescued, that does not make them the ideal risk
12 managers. Added to the fact that, yes, certain
13 products will be cleared because they are
14 profitable and they may over calculate and be over
15 enthused about clearing things that are too risky.

16 So, the Lynch amendment -- we now have
17 Lynch Light, but the Lynch Light provision is
18 extraordinarily broad, it gives the agencies power
19 to put ownership restrictions in. I'm not saying
20 that ownership restrictions have to be applied
21 across the board, but when you've got something
22 like ICE Trust with 9 banks taking 50 percent of

1 the profits, those banks have an oligopic residue
2 of power from the OTC derivatives market, they
3 translate it into the clearing, they keep -- they
4 don't have open and fair access, they're making
5 the decisions. I think ICE Trust advertises that
6 its board is independent and I think the very fact
7 that they claim independence when they were the
8 target and poster child for the initial 20 percent
9 restriction demonstrates that having independent
10 directors is not enough.

11 If there's a problem -- there should be
12 ownership restrictions. It should -- swaps deals
13 -- anybody defined as a swaps dealer or major swap
14 participant should not own more than --
15 collectively or individually -- more than 50
16 percent of the market. By the way, Goldman has
17 just announced that it's going to open its own
18 clearing facility. How is that going to be
19 managed?

20 There are incentives -- and the open
21 access has implications. If they do the clearing,
22 it's been said earlier, they'll have control over

1 exchange trading. I think the only effective way
2 -- the 20 percent rule was abandoned but you were
3 given extraordinary power. You have the power to
4 put ownership limits in and I strongly advocate
5 that that's the only way you're going to get
6 effective remedies.

7 You've got to separate -- people have
8 talked about United Trust powers --

9 MS. SCHNABEL: Michael, sorry, we're
10 just trying to get --

11 MR. GREENBERGER: Okay, let me just
12 finish. You talk about antitrust as a capability,
13 people complaining about not getting membership as
14 a capability. You do have the power to structure
15 DCOs, but you have to look at all remedies and
16 governance and ownership is a remedy, and that
17 should be adopted.

18 MR. BARNUM: There were a lot of
19 statements made in there and I guess in the
20 interest of allowing people to speak I won't try
21 to refute all of them, but I think, I guess -- I
22 guess I think it's important that we recognize

1 that the reason that the Commission is hosting
2 this panel is that these issues are complicated
3 and that there are, in fact, tensions. So we're
4 having a conflict about -- we're having a panel
5 about conflicts of interest and sort of directly
6 related to that is the question of managing the
7 tension between different useful social objectives
8 on a continuum. So, on the question of -- on the
9 question of ownership of clearinghouses and
10 expertise and the Lynch amendment, the -- it is
11 very appealing in principle to imagine that these
12 systemically important financial players into
13 which we are putting much more risk, could somehow
14 be entirely free of the nefarious influence of the
15 evil dealers who contributed to the crisis to
16 quote Mr. Greenberger. But, unfortunately, they
17 are, in fact, the market participants who need to
18 use the clearinghouses.

19 There is a version of the market
20 structure that you could put in place where they
21 would be entirely state run utilities. You could
22 do that. In many respects, from the perspective

1 of the dealer community, that would not be a bad
2 outcome for us. We would, in many respects,
3 speaking for J.P. Morgan, be perfectly happy with
4 that outcome. We want to clear more trades.
5 There's a mandate to clear more trades. It's very
6 capital intensive to clear more trades. If you
7 had a government-guaranteed, central counter party
8 run as a not-for-profit utility, that would be a
9 perfectly acceptable outcome for us.

10 That's not where we are for a variety of
11 historical reasons. Given that, then you've got
12 some very complicated tensions that you have to
13 manage. If the people with the expertise and the
14 people who are paying the bills don't participate
15 in the processes in any way, who's going to do it?
16 What kind of market incentives are you going to
17 create to make that happen?

18 The traditional vertically integrated
19 exchange model for futures works beautifully in a
20 whole range of respects for those products from
21 the perspective of liquidity and systemic risk,
22 but it has a couple problems. It is -- it does

1 seem to create some natural monopoly properties.
2 You can debate whether they're severe enough to
3 warrant action or not and that's one of the kinds
4 of tensions that needs to be balanced. In
5 addition, they work very well for the types of
6 products that naturally attract liquidity on
7 exchanges. The whole premise of this is that
8 we're pushing a whole new set of products with
9 different liquidity characteristics into central
10 counterparties. That means that you cannot apply
11 exactly the same framework. There are new
12 challenges that are being introduced. They create
13 tensions. And those tensions need to be looked at
14 rationally in a continuum framework that balances
15 different social goods against each other.

16 MS. SCHNABEL: Jason?

17 MR. KASTNER: I think it's not credible
18 to say it's complicated. The law says that you
19 have to mitigate systemic risk, promote
20 competition, and mitigate conflicts of interests,
21 right, that's what the law is. So you have to
22 look at whose incentives -- who -- what incentive

1 does my distinguished colleague, the professor,
2 have? Is he operating in a socially optimal way
3 or is he operating out of economic self-interest?
4 What are the incentives here?

5 The SDMA is not here to dance between
6 the raindrops and say it's too complicated, and
7 the SDMA is not here to say that J.P. Morgan
8 cannot have an ownership stake in a clearinghouse.
9 The SDMA strongly supports the Lynch Light
10 provision such that no economically incentivized,
11 monopolistic power can control and restrict
12 access. And I'd like to thank again the professor
13 for his very insightful remarks.

14 MS. SCHNABEL: Roger?

15 MR. LIDDEL: To go back to the question,
16 I think with established organizations, then I
17 think the concept of some combination of ownership
18 limits and voting caps actually does make sense.
19 For example, in the (inaudible) clearinghouse,
20 we've got a 5 percent voting cap and have done for
21 many years. And the reason for that was to take
22 away any incentive for anyone to build up a stake

1 greater than that so that we would be highly
2 unlikely to ever have less than 20 shareholders.
3 That works well for us.

4 However, to pick upon the point that Lee
5 Olesky made before, I think you have to be a
6 little bit careful in how you treat
7 entrepreneurial or starter ventures because most
8 of the successful starter ventures have started
9 with a relatively small number of banks sharing an
10 interest in creating something which then becomes
11 a lot bigger. So, in general, for established
12 organizations I think it makes sense.

13 Also in terms of participation,
14 ownership, and membership, you know, there is a
15 risk that I think listening to the debates so far,
16 that the impression could be left that in the case
17 of our swaps business, for example, we've got a
18 limited membership of about ten dealers who
19 collectively control about 96 percent of the
20 market. It's not true. Our membership is
21 actually growing faster than it's ever done. It
22 currently stands at, I think, now 32. We're going

1 to pipeline, which will take it up 40 within the
2 next 9 months or so, and I would expect it to
3 continue to grow beyond there.

4 Now, the question is to whether the
5 right number is 40, 50, or 60 is in my view not
6 particularly relevant. The relevant thing is to
7 make sure that the real customer's trades are able
8 to get into the clearinghouse and that we take a
9 lot of the risk out of the system and I think, you
10 know, getting too obsessed with who actually
11 qualifies and who doesn't, given the number is
12 actually reasonably large and growing, is actually
13 not the big issue.

14 MS. SCHNABEL: Lynn?

15 MS. MARTIN: I'd like to first thank
16 both commissions for inviting NYSE Euronext to
17 participate in this lively debate as it's been
18 thus far.

19 Specifically on the topic of ownership
20 limitations and voting caps, NYSE Euronext opposes
21 specific ownership limitations. We think that a
22 more effective manner in controlling conflicts of

1 interest is around good governance structure at a
2 board level.

3 You may be aware that NYSE Euronext's
4 U.S. Future Exchange -- NYSE Life U.S., is a
5 semi-neutralized structure whereby we balance the
6 views of both the independence criteria as
7 required by core principle 15 in the CFTC-DCM
8 requirements, as well as the views of NYSE
9 Euronext and our external investor firms' views,
10 such that no one board action may be enacted based
11 on the views of any one of those constituents.

12 So, it's our belief that a more balanced
13 board structure, a more balanced governance
14 structure, is the proper way to handle or
15 potentially mitigate conflicts of interest.

16 MR. McVEY: We would agree with that. I
17 think when it comes to ownership we have to
18 realize that we are embarking on a major
19 transformation of OTC markets and all of these
20 entities are going to need capital to provide the
21 market efficiencies that we're all seeking to
22 achieve. And rightly or wrongly, historically a

1 tremendous amount of the capital for clearing,
2 e-trading, data and affirmation hubs, has come
3 from the dealer community, and I think it would be
4 very dangerous to cut off an important source of
5 capital that can lead to some of the market
6 improvements that we're all seeking to achieve.

7 I think there are two important
8 components. I think it's important to take a look
9 at the governance structures to make sure that
10 there's fair representation of all important
11 market constituents at the board table and I think
12 it's important to make sure that there is nothing
13 that impedes competition, that different entities
14 have the ability to compete, whether it be for
15 clearing, trading, or data, and it's not
16 restricted to just one entity.

17 MS. SCHNABEL: Okay, I have a question
18 about ownership. So, I think that right now we're
19 discussing ownership in general and we may be
20 lumping together voting ownership and economic
21 ownership and I guess just going down the line,
22 and people can raise hands, who supports caps on

1 economic ownership without voting rights?

2 All right, can you please explain your
3 views starting with Jason?

4 MR. KASTNER: So, this goes back to
5 something that I was talking about earlier which
6 is the problem is not when the smallest member
7 fails. We've had clearinghouses in this country
8 for, you know, 150 years, and we've had numerous
9 failures along the way. But the notion is too big
10 to fail no more, to interconnected to fail no
11 more. The only way to address that -- or, the
12 most direct way to address that, is to encourage
13 both control diversity in terms of voting rights,
14 but also economic diversity in terms of
15 participation such that you could have a situation
16 where the risk is diversified over a larger amount
17 of members. In fact, it's required because no one
18 person can have more than 20 percent or whatever
19 the number is.

20 Now, it's not like we're saying no one
21 person can have more than 1 percent, and it's that
22 we're saying that you can't have a 20 percent

1 stake in 5 different DSOs, but it's all about too
2 big to fail, too interconnected to fail. And if
3 we put stuff in a clearinghouse and it's the same
4 5 guys in the room, and the biggest 3 of them
5 start to wobble, you know, it's going to be back
6 to Congress with a 1-pager asking for \$750
7 billion, which is not what the American public
8 wants. And so that's why it's critically
9 important that these ownership -- economic, both,
10 and voting, be instituted.

11 MS. SCHNABEL: Heather?

12 MS. SLAVKIN: Sure. What I'm hearing
13 from the people who support governance as opposed
14 to real caps on ownership is an argument in favor
15 of the status quo, and I think that when
16 Congressman Brown -- I'm sorry, when Congressman
17 Lynch proposed this amendment that was passed in
18 the House legislation, and when Senator Brown
19 proposed, you know, the Lynch Light version that
20 was passed by the entire Congress, their intention
21 was to create real change in recognition of the
22 fact that the current system is broken. It

1 doesn't work. That's why we're all sitting around
2 this table today. Governance is a valuable tool,
3 it's not the only tool, and I think it's our
4 responsibility to try to examine other options and
5 I think that the ownership cap is a real valuable
6 tool that can be used to mitigate the problems
7 that exist in the current system.

8 MS. SCHNABEL: Okay, Roger?

9 MR. LIDDEL: Yes, I mean, I disagreed, I
10 think, with everything that Jason said except for
11 one thing and that is having the same five guys in
12 the room would be a bad thing, and we certainly
13 would not want to have that small a number of
14 financial institutions dominating any structure,
15 that would not be appropriate any way.

16 The concept of too big to fail is
17 obviously of crucial importance, but also,
18 frankly, I think the concept of too small to
19 survive in a crisis is also important. The
20 situation today is that every clearinghouse that
21 clears futures in the world, to my knowledge, is
22 capable of managing a default of any one of its

1 members. It's a well- established process, it's
2 not that difficult, and it can do it reasonably
3 reliably. You've got access to good liquid
4 markets on exchanges to hedge and then you can
5 auction a portfolio relatively quickly and
6 relatively easily.

7 There is, however, not one clearinghouse
8 in the world today that is itself, on its own,
9 capable of managing the default of an (inaudible)
10 swap participant, including us. And what we need
11 in a venture like that is to call on a bunch of
12 market participants to come in and work on our
13 behalf to manage risk and that creates this sort
14 of mutuality of risk that actually is completely
15 different from the futures markets.

16 So, I think as we move into this next
17 phase, which is crucially important and very, very
18 beneficial at moving the OTC derivative market
19 onto clearing systems, we must make sure we don't
20 just make the assumption that they then will
21 behave like futures because for the foreseeable
22 future, in our view, they won't.

1 MS. SCHNABEL: Michael?

2 MR. GREENBERGER: I find it very
3 troubling that LCH says they do not have the
4 capital resources to clear interest rate swaps.

5 MR. LIDDEL: No, that isn't what I said.

6 MR. GREENBERGER: Well, you said you'd
7 have to bring in other parties to help you.

8 MR. LIDDEL: No, I said we bring in
9 other parties to help us manage the risk, not to
10 provide the capital initially.

11 MR. BARNUM: I think I may actually be
12 able to clarify this one and I actually think it's
13 an extremely important point that has bearing both
14 on the previous panel and on this one.

15 The market is obviously changing a lot
16 and there's obviously a lot of friction, and I
17 don't think anyone can argue that the status quo
18 as of, say, 2007, was exactly the optimal, most
19 efficient situation you would have had as a result
20 of totally unfettered competition. However, there
21 was a significant free market element to that
22 market structure and that element was that, as I

1 said before, the traditional exchange model works
2 extremely well for -- in almost every important
3 respect, for the products that naturally attract a
4 lot of liquidity in that kind of execution
5 structure, and for the products that don't work as
6 well in that structure, the OTC market essentially
7 serves as an outlet that provides different modes
8 of execution and different degrees of
9 customization to serve different needs. I'm well
10 aware that there are arguments about spurious
11 customization and OTC products that should
12 naturally be on exchange, that's fine. My
13 argument doesn't depend on saying that that's not
14 true.

15 The point is, in the new world, what we
16 are doing is putting a new set of products that
17 did not naturally gravitate onto exchanges, into
18 some parts of the traditional exchange
19 infrastructure, clearing, and then some kind of
20 organized training, but critically it's happening
21 in a de-verticalized way, we're going from a
22 vertical world to a horizontal world. When you do

1 that and you have a close-out process that you
2 need to execute because of a failing party or you
3 need prices for the purposes of margining at end
4 of day, you don't have access to one single
5 attached trading venue for the purpose of doing
6 that. So, what do you do? You need to do
7 something else and people are developing different
8 models for how to do that, but Roger's point was
9 that the close-out process, which LCH did in fact
10 run, extremely successfully, in the case of
11 Lehman's default, requires the active
12 participation of the clearing members to supply
13 liquidity because the product is not traded
14 through a central (inaudible).

15 MS. SCHNABEL: I just want to bring the
16 panel back to, I guess, the topic, which is
17 ownership caps. Basically, I mean, what Jeremy
18 just said, I, you know, I want to get some
19 clarification about that because it seems that
20 there is some conflation between ownership and
21 membership and also some conflation between
22 economic ownership and voting equity. And so I

1 just want to see, I guess, could we separate out
2 each of these elements and who's supporting what?
3 Hal?

4 MR. SCOTT: Yes. When I spoke, I was
5 saying I opposed ownership restrictions, I was not
6 talking about voting restrictions which I think is
7 a different issue, and the way I would put it is
8 not a voting restriction. I would turn it around
9 to a duty of fair representation, which the SEC is
10 quite familiar with, and is applied to their
11 regulated entities which ensures that the users,
12 more broadly defined of the exchange. And maybe
13 if you translated this into the clearinghouse, the
14 users, but not necessarily the members of the
15 clearinghouse, would have representation in terms
16 of governance. I'm just saying, this is a
17 different approach than having an ownership
18 restriction, so people would be free to own the
19 exchange singly or in groups -- or, excuse me, the
20 clearinghouse -- but that there would be some duty
21 of fair representation. ICE doesn't have that
22 requirement at the moment, but they have

1 independent directors. I think, you know, that's
2 a different idea than fair representation.
3 Independent directors, to me, are most needed with
4 public companies as under SOX when there was a
5 broad duty to shareholders. But I think what's
6 needed in this context is more the expert, and we
7 heard before that it's very important that people
8 that know what they're doing have input into
9 those, and clearly major users of these
10 clearinghouses, that is customers who clear
11 through a member. Major hedge funds, for
12 instance, have a lot of expertise, okay, in these
13 areas, they're big traders, so, you know, I think
14 we should think in terms of maybe that kind of
15 requirement as opposed to an ownership
16 restriction.

17 MS. SCHNABEL: Richard?

18 MR. PRAGER: My comments would support
19 good governance. And when I say "governance," I
20 am talking about governance with teeth. So as the
21 soul fiduciary on this panel, we talk about
22 membership, we talk about ownership, we believe

1 that very strong governance with the participation
2 of the users of these venues is critically
3 important. And as the fiduciary representing many
4 clients and many types of clients -- and I think
5 in the first panel we talked a lot about the
6 financial resources of the members. And I think,
7 Nancy, it was you who actually mentioned that the
8 customer money, the margin, is the one that gets
9 hit first. I think because we do get hit first --
10 I thought because we are the ones that are hit
11 first, we have an absolutely vested interested in
12 how well these things are -- these venues are run.
13 So, you know, we would be in support of a very
14 inclusive participation and governance with teeth.

15 MS. SCHNABEL: Lynn?

16 MS. MARTIN: I just wanted to respond to
17 one of the items that was just recently discussed.
18 We disagree with the fact that without -- with
19 ownership limitations or without the imposition of
20 ownership limitations, we are maintaining the
21 status quo. If anything, bringing market
22 participants into a more active dialogue with

1 exchanges, with clearing organizations, and with
2 each other, benefits us as we move to central
3 clearing and as we move these products to central
4 clearing. Basically we are asking the market
5 experts to opine on what structures work for them
6 and we're asking them to help us solve these
7 issues that caused or contributed to the financial
8 crisis together in a collective manner as opposed
9 to in silos.

10 MR. RADHAKRISHNAN: Before we go on to
11 Michael, I'd also like the panel's views on
12 ownership -- the ownership and governance
13 structure of exchanges and SEFs. Because so far
14 the discussion seems to be focused on clearing and
15 that's not a bad thing, but, you know, there are
16 also exchanges and SEFs, and if the panelists
17 would address that, it would be much appreciated.
18 Michael?

19 MR. GREENBERGER: Yeah, I think
20 basically, you know, something that the CFTC
21 should go back and look at is your 2007 rule. The
22 result of that rule I'm not very crazy about, but

1 there was a lot of thinking that went into that
2 that's applicable to this now. And one of the
3 thoughts there -- that's the Chicago Mercantile
4 Group's, which is an exchange and a clearing
5 facility board of governance in a regulated market
6 -- basically, you know, I think the vertical
7 relationship between clearing and exchange trading
8 is very, very strong, and so whatever we say here
9 I think goes for both clearing and exchange
10 trading. And I think as this market develops,
11 it's going to develop like the regulated futures
12 market where the clearing is not the big dog and
13 the exchange following it, it'll be the exchange
14 with clearing following it, as is true in the
15 regulated markets.

16 I still -- if we want governance with
17 teeth, governance with teeth will have ownership
18 limitations. You can talk about fair
19 representation, board governance, the fact of the
20 matter is, and I think this will bear its way out
21 in the comments to you, that does not protect fair
22 and open access. The way fair and open access

1 will be maintained is I'm not saying that every
2 bank cannot be part of the majority ownership, but
3 the big swaps dealers who have an oligopic
4 interest in the OTC market, 5 of them had 90
5 percent of the market, they've now set up their
6 own exchange in effect. Some of them now want to
7 set up their own individual clearing facilities,
8 there will be lock outs there not because of
9 capital that conforms to what traditional
10 clearinghouses require, but capital requirements
11 and other discriminatory rules that are excessive
12 to the risk management function and shut people
13 out. You can't compare OCC to a swaps clearing
14 facility that is dominated by swaps dealers. I
15 completely agree OCC, CME, the traditional
16 clearinghouses, must have strong risk management,
17 should have input from their members. They are a
18 model, but their membership acceptance is not as
19 restricted as what we are seeing with the swaps
20 clearing facilities that are being brought about
21 by the banks. And I think in those situations --
22 I shouldn't say banks, I should say swaps -- major

1 swaps dealers. In those situations, not every
2 situation, ownership limitations should be imposed
3 so they do not have majority control of the
4 institution.

5 MS. SCHNABEL: Just to transition into
6 the next topic, which is the board of directors,
7 composition of the board of directors and
8 composition of board committees, for those of you
9 who do not support caps on voting, voting rights,
10 or voting equity, how do you, I guess, think about
11 the relationship between voting equity and the
12 board of directors? Because ultimately the board
13 of directors would be elected by the voting
14 shareholders.

15 MR. SCOTT: I would just like to make a
16 general point, maybe I should have been on the
17 first panel to make this point, but -- I've been
18 holding it in so I've got to get it out.

19 You know, it seems to me that there's
20 one major regulator who has a big interest in this
21 who's not at this table: It's the Federal
22 Reserve.

1 MS. SCHNABEL: They're here in this
2 room, by the way.

3 MR. SCOTT: Well, I'm glad. Maybe they
4 should move to the table because, as you know,
5 under Dodd-Frank, they have the power to declare
6 clearing organizations as systemically important
7 and thereby become their major regulator. Now, as
8 we sit here, CFTC and SEC, adopting or thinking
9 about conflict rules, these rules have a major
10 impact on the systemic risk. And we've talked a
11 lot about that in the first sessions of these
12 (inaudible). So, it seems to me that this process
13 needs to be coordinated. Now, this is another
14 advertisement for a recommendation for committee
15 that fell on deaf ears which was serious
16 structural reform, but I would say that at the
17 minimum, given where we are, you know, I hope that
18 the Fed becomes a major party to this discussion.

19 MR. RADHAKRISHNAN: You should be aware
20 that, you know, the SEC and us are in very close
21 consultation with the Fed, but a couple of points,
22 it's the FSOC, the Stability Oversight Council,

1 that makes the determination and we still remain
2 the primary regulators. So, I think it's only
3 when we are found to be deficient that the Fed
4 gets defensive.

5 MR. SCOTT: Well, again, not an
6 advertisement for structural reform, but, you
7 know, if we don't get the regulatory structure
8 right on this, we could make a lot of mistakes
9 here. And all I'm saying is, yes, you are the
10 functional regulator, but they are the party, if
11 these institutions are designated as systemically
12 important, who have overall responsibility for the
13 systemic stability of our system. So you're going
14 to have to work out amongst you how that happens.

15 MR. RADHAKRISHNAN: Here's a question on
16 --

17 MR. SCOTT: I'm sorry. I apologize for
18 this digression. I do think it's important that
19 as we go forward on this conflicts issue we take
20 this into account.

21 MR. RADHAKRISHNAN: So, to follow up on
22 Nancy's question, the compositions of boards of

1 directors, not just at the clearinghouses, but
2 also at DCMs themselves, should our two agencies
3 mandate how that board should be composed? Should
4 we impose a certain amount of independent
5 directors? And please tell us how we should
6 address boards of publically traded companies
7 because I believe, you know, under the SEC rules
8 there are different requirements if you happen to
9 be a publically traded company, so should we defer
10 to SEC rules of publically listed companies or
11 should our rules be different assuming that we can
12 get there?

13 MR. BARNUM: I'm going to take a shot at
14 actually answering some of these questions as
15 briefly as possible because we all have other
16 things we want to say, too, so a couple things.
17 One, I think it's clear that economic stakes are
18 less risky and problematic than voting stakes.
19 Does that mean that there's no appropriate
20 regulatory oversight of those whatsoever? No,
21 clearly not, but on the scale of things that I
22 would worry if I were regulating this thing, I

1 would worry the least about non-voting economic
2 stakes because those are the ones that are going
3 to have the least impact on things like
4 governance, strategy, innovation, membership, and
5 all the things that directly feed into the policy
6 objectives which are, in my opinion, primarily
7 systemic risk and secondarily, you know,
8 competition and maximum liquidity and access. So,
9 I think that's the first thing.

10 Now, to go to the next question, if you
11 then talk about composition of boards and public
12 companies, the answer probably has to depend a
13 little bit on, again, private versus public. So,
14 private companies will have boards. Probably in
15 private company boards that board will drift in
16 more to some of the issues which might involve
17 systemic risk, the public company board is going
18 to be more constrained by traditional fiduciary
19 responsibilities to the shareholders so
20 realistically, I think the regulatory process is
21 going to have to differentiate between those
22 aspects of governance which speak directly to the

1 policy objectives of systemic risk and will
2 probably have to have segregated boards for those
3 types of decisions that are to some degree
4 different from the boards that are in charge of
5 the commercial objectives of the entity in
6 question.

7 Unfortunately, I think what that means
8 is that you wind up with kind of a wishy-washy
9 answer, which is that it depends and it's case by
10 case and it's going to be tedious and intensive
11 rulemaking. But the alternative is to wind up
12 with a very course tradeoff between the need to
13 allow people to have commercial incentives to
14 develop useful pieces of market infrastructure and
15 insuring that once those things are developed,
16 they don't create either anti-competitive patterns
17 or excessive systemic risk.

18 MS. SCHNABEL: Jason?

19 MR. KASTNER: I've got several points
20 that I'm going to make very quickly, but first I'm
21 going to give a history lesson on the Federal
22 Reserve system. We have a decentralized system

1 and there's a very good precedent and a good
2 reason for decentralization and federalism and the
3 same principles when they were crafting the
4 Federal Reserve Act in 1913 apply today which is
5 that you don't put all your eggs in one basket and
6 you spread it around, and the best way to do that
7 is to put ownership restrictions on SEFs,
8 exchanges, DCOs, the idea is to diversify.

9 Now, this point about the status quo or
10 not, it's -- if we allow risk to be concentrated
11 in centrally cleared environments with the same
12 three guys, five guys, it's worse than the status
13 quo because now you've got all this stuff
14 concentrated in a clearinghouse whereas before it
15 was bilateral and there's all these ISDA
16 agreements and everything's -- you know, at least
17 maybe if the one thing fell over, it certainly
18 wouldn't fall over, but I would say it's the
19 status quo but worse.

20 Thirdly, this point about too small to
21 survive, again, the problem is not when your small
22 clearing member falls over, it's when the big

1 three guys -- so, as long as the clearinghouse is
2 robust and diversified and decentralized, right,
3 it's a robust system which addresses the issue of
4 too big to fail.

5 MS. SCHNABEL: Richard?

6 MR. PRAGER: I think perhaps to answer
7 Ananda's question, if you go back to Jeremy's
8 example, if this was, in fact, a utility, a
9 government-owned utility, and then you first ask
10 yourself, now we're taking away the economic
11 incentives, how would you want to govern that
12 utility and what are the appropriate oversight
13 boards or committees, whether they be a risk
14 committee or a new product approval committee? So
15 I think there's where perhaps the agencies should
16 look at some sort of governance structure that
17 should be followed with, you know, with all the
18 prudence and risk management tools available run
19 by the experts with a very inclusive participation
20 of all of those who truly has their money at risk,
21 which, of course, I would argue includes the buy
22 side.

1 I think once that has been established
2 then you can layer on the question in a public
3 context of what -- whether it matters, if it's
4 voting shares or non-voting shares, but at least
5 you know you have a very solid structure that the
6 agencies themselves would have oversight of.

7 MR. WORKIE: If I could just briefly go
8 back to the ownership issue, should we be thinking
9 differently about ownership with respect to
10 individuals as opposed to groups? In other words,
11 should we -- are there differences in the way we
12 should be thinking about restrictions based on the
13 cost of people as opposed to a certain person or
14 certain individual can't own more than a certain
15 percentage? Something like that.

16 MR. GREENBERGER: I think it's hard to
17 answer that question because for example in the
18 situation of Goldman, you don't know whether
19 Goldman is bringing in other -- is Goldman going
20 to be the only guarantor or are they going to
21 bring other members in the organization?
22 Certainly to the extent there's a one-member

1 clearinghouse you've got real problems on your
2 hand in terms of you're putting all the risk in
3 the hands of one institution, so I think you need
4 to find out what these ideas are of single
5 corporation clearinghouses and how they're going
6 to work.

7 Getting back to the original question,
8 again, and I think in 2004 to 2007 the CFTC
9 thought these issues through very carefully. They
10 originally proposed for exchanges, regulated
11 exchanges, 50 percent independent boards of
12 directors. My view would be no matter who owns --
13 there's a sliding scale here. If the ownership
14 requirements are tough in terms of restrictions,
15 then you would worry less about the board, but
16 even with the toughest ownership restrictions, 50
17 percent -- I believe at least 50 percent of the
18 board should be independent and I would -- I see
19 my good friend Mark Young sitting over there -- I
20 would adopt 80 percent of what the Futures
21 Industry Association advocated with regard to the
22 need for independence on the board of the Chicago

1 Mercantile Group in that period. Their arguments
2 for independence, how it's defined, look-back
3 periods, are very, very strong. They were in the
4 situation then of being Wall Street, being shut
5 out of Chicago, and they advocated for open and
6 fair markets and their arguments, I think, should
7 carry the day for all exchanges.

8 MS. SCHNABEL: All right, only if you're
9 very brief, Jeremy.

10 MR. BARNUM: I just wanted to say, look,
11 again, unfortunately, there is a tension, there is
12 a balancing act. Anyone who's been part of a risk
13 management organization at a large bank knows that
14 there is a risk of groupthink and so we know the
15 focus here has got to be about risk committee. If
16 the risk committee suffers from groupthink, then
17 that creates systemic risk. That's bad.
18 Independence is good. There should be as much
19 independence as is possible on the risk committee.
20 But there's another side to that which is that
21 whether we like it or not, expertise in these
22 markets is not broadly available and so you have

1 to have a balance between your desire for
2 independence and the need to have expertise. And
3 when you sacrifice independence in favor of
4 expertise, it's important to remember that if you
5 have non-independent people of expertise whose
6 capital is at risk, then at least from the
7 perspective of systemic risk -- I'm not speaking
8 to open access independently of that -- but at
9 least from the perspective of systemic risk, you
10 could be reasonably assured that the incentives
11 are aligned.

12 MR. RADHAKRISHNAN: We've got a few more
13 questions that we need to ask. Jordan, go ahead.

14 MS. O'REGAN: Although Michael just
15 answered this question, could other panelists
16 discuss whether there is a certain percentage of
17 independent directors or public directors that
18 would alleviate the concerns we've been
19 discussing.

20 MS. SCHNABEL: Okay, actually I'm going
21 to take a vote if that's okay because that might
22 be the easiest.

1 MR. RADHAKRISHNAN: And also the other
2 issue is, what does independent mean?

3 MS. SCHNABEL: Okay, let's start with
4 what does independence mean because then we can do
5 the vote on percentages. Hal?

6 MR. SCOTT: Well, there's no one
7 definition of independence. You can start with,
8 you know, the New York Stock Exchange's
9 definition. Numbers of exchanges have adopted
10 definitions as (inaudible) and probably Sarbanes-
11 Oxley. So basically -- but I would make the point
12 that, you know, we don't necessarily need
13 independence here, what we need is a
14 non-membership point of view and expertise, the
15 users of the system. You know, we need to ensure,
16 if we're going to independent directors, they have
17 expertise.

18 The most important thing is containing
19 systemic risk and we need to make sure that the
20 people who are participating in this understand it
21 and know what it is. So I would not go -- I think
22 we need independence on publically owned

1 companies, publically owned exchanges to protect
2 the shareholders. But in non-publically owned
3 institutions I would focus on the user's
4 representation rather than independent directors
5 which is a concept that we've mainly, to this
6 point, applied to public companies.

7 MS. SCHNABEL: Michael?

8 MR. GREENBERGER: I again would go back
9 to the Futures Industry Association comments.
10 Their definition was no material relationship, but
11 no relationship with the company. There was a
12 one-year look back, they proposed a two-year look
13 back. I think the look back could be even
14 stronger. There was a limit to \$100,000 in a
15 service provider. If you had more than that you
16 couldn't be a member. FIA said there should be no
17 client-customer relationship and that it should
18 extend to close relatives as well.

19 MS. SCHNABEL: Did you have something
20 that you wanted to say?

21 MR. McVEY: Just a couple of things and
22 we've touched on a number of topics, public versus

1 private and independence of directors and we have
2 a little bit of experience with both having been a
3 private company and now in the public arena. And
4 I think that there are already significant
5 obligations of independence on public companies,
6 some of which serve as a good model, I think, for
7 good governance structures that should apply to
8 clearinghouses and SEFs and data warehouses and
9 the like.

10 I personally think that one of the most
11 important areas to focus on is the governance and
12 nominating committee. How do people get on these
13 boards? And if there is a requirement that that
14 process be independent I think you would get both
15 qualified people that are going to look after the
16 best interest of the company, and you would get
17 better independence on these boards.

18 The second requirement that I would look
19 to is that most major industry groups should be
20 represented on these boards. I don't think that
21 there's a hard limit on the number of seats that
22 can be held by any one constituent but certainly I

1 think when you look at the importance of these
2 entities, the dealer community should be
3 represented, the investment community should be
4 represented, there should be quality risk
5 management capabilities around that board, so I
6 think broad industry representation should be a
7 key principle as well.

8 I also think that to increase the level
9 of duty and care among the directors on the entity
10 itself, there should be a requirement that the
11 directors are able to be compensated for their
12 work. Some of them go into these jobs without
13 being able to take compensation because they know
14 there's a conflict of interest because they're
15 there primarily to represent the interests of
16 their own firm. So, I think if you would really
17 look into the corporate and governance --
18 nominating process, you require industry
19 representation from all groups and you require
20 that directors are able to be compensated, we
21 would have a better model.

22 MR. GREENBERGER: Can I make one quick

1 point? I wanted to make clear the \$100,000 would
2 not apply to compensation, that's in the -- in the
3 rules they apply it, but as a director -- I don't
4 put any limits on directors' compensation.

5 MS. SCHNABEL: Heather?

6 MS. SLAVKIN: I agree that the SEC has
7 some good provisions in place with regard to
8 public companies that provide for independence on
9 the board. I think, though -- I agree also that
10 governance and nominating committee independence
11 is important, but I think one thing in addition
12 that needs to be considered here is that there
13 needs to be a real democratic process in place for
14 actually electing the members of the board of
15 directors. The current process for public
16 companies where you could either vote for the
17 board nominee or not vote for the board nominee,
18 but can't actually vote against anybody or put up
19 an opposing candidate doesn't result in a real
20 democratic process and that causes some concerns.

21 I also want to go back to the issue that
22 was raised before about ownership restrictions

1 versus voting caps. I actually disagree with what
2 the gentleman from JP Morgan said when he said
3 that he doesn't think that having an economic
4 stake without having a voting interest is a
5 concern. I think most of us can imagine a
6 situation where someone owns 5 percent of our
7 company and asks us to do something. I don't
8 think it matters if that person gets to vote for
9 the board of directors, that person has real
10 influence regardless of whether it's formal
11 influence, there is going to be influence over the
12 decision making, there's going to be influence
13 over the strategy and innovation and the
14 trajectory of the institution in general, so I do
15 think we need to look at ownership restrictions
16 related to voting interests as well as related to
17 economic interests even when they're not tied to
18 actual voting shares.

19 MR. BARNUM: One sentence response. I
20 didn't say it didn't matter at all, I said that on
21 the scale of priorities, it would be at the
22 bottom.

1 MR. BERNARDO: And I think as a SEF we
2 can manage the conflicts of interest and the act
3 doesn't require ownership limits but it does
4 require compliance with the core principles and we
5 need to have rules that are limiting that access.

6 MS. SCHNABEL: Okay. I actually have a
7 very simplistic question. Given that
8 independence, you know, has not yet been defined,
9 I know that this is hard, but in terms of board of
10 directors, 50 percent independent, who supports
11 it, who doesn't? Sorry, raise hands.

12 MR. SCOTT: Of what are we talking
13 about? Any entity? All entities?

14 MS. SCHNABEL: DCOs.

15 MR. SCOTT: Publically owned? Privately
16 owned?

17 MS. SCHNABEL: Okay, clearing agencies,
18 exchanges, swap execution facilities. Okay, let's
19 start with privately owned.

20 Fifty percent, who's for it? I've got
21 Michael. Anybody else? I've got Heather. Okay.
22 Less than 50 percent, let's say 40 percent.

1 Anybody?

2 UNIDENTIFIED: Still private.

3 MS. SCHNABEL: Still private. Okay.

4 Thirty percent?

5 MR. BARNUM: I would say 30 percent is
6 desirable. It would be nice if you get it. If
7 you mandate it, it could be a problem.

8 MS. SCHNABEL: Okay, and now public, 50
9 percent? All right, Hal, Michael, Heather. All
10 right, now we're going to move on to committees.
11 Lois, the next question?

12 MS. GREGORY: I have a question. In
13 terms of board committees, what board committees
14 are conflicts of interest most manifest on and how
15 do we address that? With independence
16 requirements? And if so, what percentage there?

17 MS. SCHNABEL: Okay, Hal.

18 MR. SCOTT: Again, I would not have -- I
19 wouldn't answer this question any differently for
20 the committee than I answered it for the
21 organization as a whole, so if it's private, I
22 would not insist on any independent directors on a

1 committee since I haven't insisted on it for the
2 board as a whole. But I think narrowing in on the
3 other aspect to your question as to what are the
4 key committees we need to worry about, where I
5 think the issue should be solved by representation
6 of the users, not by independence requirements,
7 would be the membership committee, the risk
8 management committee, and probably the governance
9 committee which would be, you know, if the
10 organization had such a governance committee.

11 So, I think those would be three key
12 committees where you would want to have
13 representation from not just the members of the
14 organization.

15 MS. SCHNABEL: So, let's talk about fair
16 representation a little bit more. We recognize
17 that's a question that's separate from
18 independence. What -- I guess, at what threshold
19 is representation fair? What should we look at to
20 make sure that all market participants or all
21 users have a say in the operation of a clearing
22 agency or an exchange or a swap execution

1 facility?

2 MR. RADHAKRISHNAN: And then to add to
3 that, how do we include them? For example, let's
4 say you have an organization which says, I
5 represent this group of people and I want to be
6 represented, as opposed to a citizen of the
7 street. Why should he or she not be included?

8 MR. SCOTT: I would address this, first
9 of all, by not a one-size-fits-all approach. I
10 think if you have a duty of fair representation
11 you should allow each organization to come forward
12 with a plan that in their view justifies or takes
13 account of this fair representation. Different
14 organizations may have different ways of doing
15 this. I don't think we should set a magic number,
16 but I think there should be a duty and, you know,
17 so I guess that would be my answer.

18 MR. PRAGER: I think if you do -- I do
19 think it is important to look at the
20 participation. This is meant to address market
21 reform and what's good for all the markets and
22 healthy, stable financial markets. So, you know,

1 there is empirical evidence of who, in fact, is
2 participating in these markets so I think there
3 you can get a pretty good sense of the dealers,
4 the investors, end users, corporations, and they
5 need to have a seat at the table so I would be in
6 favor of reserving certain seats at these
7 respective committees. I'm probably a little bit
8 less of the mind you have to be absolutely --
9 prescribe how many and in what committees, but
10 there will be basic committees where you could
11 have conflicts to your question before of what
12 products can come on and, you know, there's this
13 concern that there might be some perverse
14 incentive not to have a product come on. Well, if
15 the users are sitting there at those committees
16 and saying, yes, please, we need that, it can be
17 prudently managed, and you listen to some of the
18 comments from the earlier panel about, you know,
19 balancing those needs of what can be prudently
20 risk- managed, and if it meets those criteria, I
21 think that's where you get a very balanced view of
22 what should be accepted as a clearable product or

1 not.

2 So, I do think that, you know, we're
3 trying to serve the needs of the entire
4 marketplace and, you know, each of those
5 constituents should have a seat at these
6 respective committees.

7 MS. SCHNABEL: Roger?

8 MR. LIDDEL: First of all, I think -- I
9 don't think everybody can be represented but I
10 think you can have, you know, individual
11 organizations that are representative of a sector
12 and that, I think, can be quite successful.
13 Similarly, I don't think you need many truly,
14 truly independent directors. A small number, I
15 think, can keep a board honest.

16 And indeed I think this is an important
17 time in our evolution, in the market evolution,
18 and we're -- I mean, we're actively discussing
19 now, internally, you know, bringing in different
20 representations into our board potentially and
21 onto some of our committees, you know, getting
22 some significant buy side involvement, but frankly

1 that's not because of any views we've got on any
2 conflict of interest, and that really rarely comes
3 up at all, it's simply that we would actually
4 benefit as an organization from having more input
5 in expertise than a different sector of the market
6 that is now becoming more important to us. So,
7 that's the reason and motivation for doing it but
8 it has the same end result, I think.

9 MR. BARNUM: I just wanted to expand
10 briefly on what Mr. Prager said from Blackrock
11 because I think that you raise a very useful point
12 which is that one of the really big benefits, I
13 think, of the legislation is the swap data
14 repository requirement and that's going to mean
15 that the regulatory community has a complete
16 visibility over (inaudible) and that makes it
17 quite easy to sort of monitor this and surveil it
18 and sort of say, hey, wait a second, it appears
19 that there's this community of people who's
20 critical of this market. I can see it from the
21 data, and they're not represented. And I think
22 that's a very useful tool. In fact, in a number

1 of these policy issues, the increased visibility
2 of both volumes and positions will, I think,
3 enable this to be done much more fairly.

4 MR. GREENBERGER: I don't think fair
5 representation can be viewed in isolation from the
6 other issues. If you've got a small number of
7 swaps dealers running a company I think you'll
8 find that both the independent directors and the
9 fair representers are going to fall short of the
10 kind of concerns from the broker community that
11 you've heard today. So, it's not an isolated
12 situation. To the extent there is broader
13 ownership and there will be the intermediaries who
14 will want ownership, you're going to have a better
15 board, whether it's independent or not, and better
16 fair representation. I think somebody who's there
17 for fair representation in an oligopic thing is
18 really never going to be able to do their job and
19 so I would just say that I think there's a
20 relationship.

21 MR. SCOTT: Just one last point. I have
22 to go early. There's another leg of this stool

1 here, this is the regulators. So, whatever these
2 organizations do with respect to governance
3 membership criteria or whatever, should be
4 reviewed and reviewed in detail, okay, by the
5 primary regulator. So, this is another protection
6 of the system. So, you know, we heard from the
7 first panel potential conflicts around things like
8 how much capital you require of the member, do you
9 -- nobody brought it up, but it's an issue,
10 whether you accept a parent guaranty of a member
11 in lieu of the member's own capital. Whether the
12 member itself has the ability to resolve contracts
13 in the extent of default, or could this be
14 contracted out to a third party which have that
15 capability. A number of these issues, and, you
16 know, new products, whatever it is -- these rules
17 should come to the regulator and the regulator
18 should review these rules. So, another key part
19 of the protection of the public here, an essential
20 part, is not just the governance structure, but
21 it's the regulatory structure that is looking over
22 all of this. And so, Michael, I would say that --

1 you know, I think you would agree, whatever you do
2 in ownership, we need a strong regulatory review
3 function. In my view, that plus governance is
4 enough, but others may and have disagree.

5 MR. RADHAKRISHNAN: So, while I think
6 it's fair to say that the regulators represent the
7 views of -- well, are here to make sure that the
8 public interest is protected, do you think that
9 there is a place for the American public, however
10 you pick them, to be on the boards? Or is that
11 completely unrealistic? Because all we've talked
12 about is interest of market participants, but as,
13 you know, Jason mentioned, one of the reasons why
14 Congress went through this exercise is because the
15 taxpayer footed an enormous bill. So, to make
16 sure that the taxpayer doesn't do that again, is
17 there a place for the average man or woman on the
18 street to be represented, realizing that how you
19 pick that man or woman on the street is going to
20 be quite difficult?

21 MR. GREENBERGER: I think I'm going to
22 give you a surprisingly conservative answer on

1 this. I do agree with what has been said, that
2 you need experts on the board. What I disagree
3 with is that all expertise comes from five swaps
4 dealers or it all comes from people who work for
5 banks. There are academics, former regulators,
6 and, you know, other participants in the market
7 who have talked today about their need for open
8 and fair access. I think that kind of diversity
9 on the board is important. I would worry very much
10 about putting somebody on the board as a
11 representative of the American public who isn't
12 going to be able to abide by the fiduciary
13 relationship to the institution, and these
14 clearinghouses and exchanges and swaps execution
15 facilities have a public -- I think that's what
16 you're saying. Congress clearly sees them not as
17 private, but having a public merit of stabilizing
18 the economy, but I think to fulfill that you do
19 have to have expertise on the board.

20 MR. PRAGER: Yeah, and I would agree
21 that you need that expertise to really add value
22 to the equation and if you do have, you know,

1 balanced participation, including fiduciaries like
2 ourselves, we do represent the person on the
3 street through their pension funds and other
4 monies.

5 MR. BERNARDO: I just wanted to
6 emphasize that the corporate governance core
7 principles applicable to derivatives, clearing
8 corps., and exchanges, is not applicable to SEFs.

9 MS. SLAVKIN: I think if the question is
10 do we want regulators to pick a random person from
11 the street and put them on the board of directors,
12 that would be problematic. I think if you're
13 talking in the context of a public company where
14 the representative of the public would most likely
15 be somebody who was selected by the shareholders,
16 they would have to win an election and most of the
17 votes in that election would be placed by
18 institutional investors who are sophisticated, who
19 understand the markets, who simply aren't going to
20 vote for somebody who doesn't know what's going
21 on, that doesn't have the sophistication and the
22 expertise to make a significant contribution to

1 the board. And the people who are responsible for
2 selecting that individual and running them as a
3 candidate aren't going to put somebody up who
4 doesn't have the expertise because oftentimes
5 these are the same people that have an ownership
6 interest and want to see the very company succeed.
7 So, I do think there could be a place for an
8 independent individual that's nominated by
9 shareholders who have an economic interest in the
10 financial stability and the success of the firm
11 to, you know, have a seat on the board, but I
12 don't think any random person off the street
13 should have that position.

14 MS. SCHNABEL: Lynn.

15 MR. RADHAKRISHNAN: Lynn, yeah.

16 MS. MARTIN: I just wanted to respond to
17 one item that was just brought up around the
18 application of the core principles that apply to
19 exchanges applying to swap execution facilities.
20 I would actually argue that it's important for
21 those same core principles that apply to DCMs and
22 DCOs, particularly around conflicts of interests,

1 governance manners, and independence requirements
2 potentially, so specifically core principles 15,
3 16, and 17, they actually provide a useful
4 framework for mitigating these type of conflicts
5 on the boards of exchanges and the boards of DCOs.
6 So I think that we should think about potentially
7 extending those core principles to apply not only
8 to DCMs and DCOs, but to swap execution facilities
9 as well.

10 MS. SCHNABEL: Okay, Jeremy.

11 MR. BARNUM: Sorry, just because I think
12 that's actually a really important point because
13 so far all the questions that I've been asked have
14 sort of presumed that exchanges, SEFs and DCOs are
15 sort of the same for the purposes of these
16 governance issues and I actually think -- I
17 believe that they're extremely different and that
18 understanding those differences and getting it
19 right is really critical. That doesn't mean that
20 we're against, obviously, appropriate
21 representation and governance on SEFs, but I think
22 you have to look kind of at the scale and for me

1 the scale is the most critical, trickiest place
2 where you have to balance systemic risk with other
3 interests is the risk committee of the DCO.
4 That's on one end of the continuum. On the other
5 end of the continuum is the board of directors of
6 a publically traded company where, you know,
7 really, the real question is, these traditional
8 questions that have obviously been heavily debated
9 for years about how to manage that governance
10 process (inaudible) shareholders, but it's pretty
11 well removed from the micro functioning of the
12 market as it relates to systemic risk. And I
13 think SEFs, on that continuum, kind of lie in an
14 interesting place. I've heard this is a
15 controversial view but I think it's -- in my
16 opinion, SEFs are not particularly important from
17 a systemic risk perspective. I think SEFs serve a
18 very important and relevant role in the
19 legislation, but on the scale of things they don't
20 do that much about systemic risk. Systemic risk
21 is more happening in clearing and in post trade
22 than happening in pre trade. There are other

1 policy objectives that are being served by SEFs.

2 MS. SCHNABEL: Okay, it's 12:00, so
3 we're going to try to wrap up. So, I have one, I
4 guess, thematic question. Just playing off of
5 what Hal had been saying, and unfortunately he's
6 not here to really defend himself, but it seems as
7 if there is a three-legged stool that we've been
8 all talking about and the first leg is ownership
9 and voting; the second leg is board of directors
10 and their composition and fair representation; and
11 the third leg is objective criteria that
12 regulators should be looking at and reviewing.

13 Of those three legs, which do you think
14 are important or are they all important?

15 MR. BARNUM: They're all important and
16 objective criteria is the most important.

17 MR. GREENBERGER: They're all important
18 and ownership is the most important. It's the
19 only -- Hal made the point that I can't argue
20 with, that regulation is very important, but you
21 as regulators -- because I was once in somewhat
22 similar situation -- do not want to be on the

1 phone every day with people complaining about not
2 having access, this, that, and the other thing.
3 That's something you have to deal with up front to
4 limit your regulatory responsibilities on the back
5 end.

6 If you set this up so that an antitrust
7 complaint or a phone call is the remedy, it's not
8 going to work. This is one part -- the board
9 governance or an ownership structure is one part
10 of many powers you have. Don't let people talk
11 you into the fact that, oh, you have these other
12 powers, so don't worry about this. Because when
13 you get to the other powers they'll be saying, oh,
14 you had the board governance power, don't worry
15 about this. They all have to go into effect at
16 the same time.

17 The final point I would make, SEFs
18 should not be treated any differently. It is well
19 known that in the legislative process there was a
20 big concern that SEFs were going to be a less
21 regulatory environment to satisfy the need for
22 exchange trading. You cannot let that happen. I

1 think the final legislation doesn't let that
2 happen, and SEFs have to have the same governance
3 process as everyone else.

4 MR. PRAGER: I think all three are very
5 important. As I spoke earlier, I think the fair
6 representation in governance is very important and
7 I also think the regulation is important. These,
8 certainly the DCOs, are the new too big to fails
9 so they need to be monitored very carefully.

10 MR. LIDDEL: I think they are all
11 necessary. I think they have different
12 importance. I think that governance and
13 regulation are the two most important legs. I
14 think ownership is less important, frankly. I
15 mean, our organization has had lots of changes in
16 ownership structure over the years, small number
17 of banks, huge number of financial institutions,
18 exchanges, back and forth, and it's never, as far
19 as I can tell, made any meaningful difference to
20 how the company operates.

21 MS. MARTIN: I believe they're all
22 important. Regulation is one of the most

1 important. We should look at what worked well
2 during the financial crisis and those would be the
3 exchanges, the centrally cleared markets, and we
4 should take that into account when we're
5 promulgating policies for swap execution
6 facilities.

7 MR. KASTNER: I think they're all
8 important but I would think that the most
9 important question is, what does the customer
10 want? What is good for the buy side customer?
11 And we apply that with transparency, and we apply
12 that by looking at different incentives. And the
13 question, as you write the rule, should be, what
14 is the incentive, really, behind this position or
15 that position, and what is good for the customer
16 first?

17 MR. McVEY: I think they are all
18 important. I would put them in the order of,
19 first, objective criteria around some of the key
20 issues that have been discussed this morning in
21 terms of which swaps are eligible for clearing
22 which then triggers the exchange or SEF

1 requirement at the top of my list. I would put
2 good governance and the board and decision-making
3 process second and ownership third.

4 MR. BERNARDO: I think they're all
5 important. I do think the objectiveness is
6 possibly -- is probably the most important, but
7 going back to the crisis, I don't think that the
8 markets would have acted as efficiently as they
9 did if it were not for the inter deal brokers who
10 were the members of the WMBA.

11 MS. SLAVKIN: I think they're all
12 equally important.

13 MR. RADHAKRISHNAN: All right. Well,
14 thank you. This brings us to an end of this
15 roundtable. We really appreciate the spirited
16 discussion and the preparation that the panelists
17 have shown.

18 I again will remind you of our
19 invitation to send us comments at the Federal
20 Register. Please send us your comments so that we
21 can do thoughtful rulemaking.

22 Thank you so much.

1 (Whereupon, at 12:06 p.m., the
2 PROCEEDINGS were adjourned.)

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