

UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION

GLOBAL MARKETS ADVISORY COMMITTEE

Wednesday, June 2, 2004

1155 21st Street, N.W.
First Floor Hearing Room
Washington, D.C.

The hearing in the above-entitled matter
convened, pursuant to notice, at 2:10 p.m.

MEMBERS PRESENT:

WALTER LUKKEN, Commissioner and Chairman
of the Committee

JAMES NEWSOME, Chairman, Commodity Futures
Trading Commission

SHARON BROWN-HRUSKA, Commissioner,
Commodity Futures Trading Commission

ANDREA CORCORAN, Director, Office of
International Affairs, CFTC

PATRICK McCARTY, General Counsel, CFTC

MEMBERS PRESENT (continued):

GREGORY MOCEK, Director, Division of
Enforcement, CFTC

RICHARD BERLIAND, J.P. Morgan Securities

ROBERT COLLINS, New York Mercantile
Exchange

ADAM COOPER, Citadel Investment Group, LLC

GEORGE CRAPPLE, Milburn Ridgfield
Corporation

BERNIE DAN, Chicago Board of Trade

JOHN DAVIDSON, Morgan Stanley

KEVIN DAVIS, Man Financial, Inc.

MICHAEL DAWLEY, Goldman, Sachs & Co.

DENNIS DUTTERER, The Clearing Corporation

HARRY FALK, New York Board of Trade

RON FILLER, Lehman Brothers

ARTHUR HAHN, Katten, Muchin, Zavis,
Rosemann

ROBERT KLEIN, Citigroup Global Markets,
Inc.

ROY LEIGHTON, UK Chairman, CALYON

BONNIE LITT, Goldman, Sachs & Co.

JOANNE MEDERO, Barclays Global Investors

SATISH NANDAPURKAR, Eurex US

MEMBERS PRESENT (continued):

SUSAN M. PHILIPS, George Washington
University School of Business

BOB PICKEL, International Swaps &
Derivatives Association

DAN ROTH, National Futures Association

KIMBERLY TAYLOR, Chicago Mercantile
Exchange

EMILY ZEIGLER, Willkie, Farr & Gallagher

TABLE OF CONTENTS

Agenda Item	Page
I. Call to Order and Introductions.....	5
II. Report on Activities of CFTC Office of International Affairs.....	14
III. Cross-border Clearing and Linkages.....	32
IV. International Regulatory Coordination/ Enforcement Harmonization.....	125
V. Discussion of Future Meetings and Topics	134
VI. Adjournment.....	140

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

2 I. CALL TO ORDER AND INTRODUCTIONS

3 COMMISSIONER LUKKEN: Welcome, everyone.
4 I'm Commissioner Walt Lukken. Welcome to the CFTC
5 in Washington on a wonderful day. Hopefully you've
6 avoided the cicadas. We were trying to order
7 order up some nice weather for you. So we're
8 glad it happened.

9 I wanted to welcome everybody here, and
10 this is the first meeting of the reconstituted
11 Global Markets Advisory Committee. In particular,
12 I'd like to recognize our Chairman, Jim Newsome,
13 sitting next to me, and next to him, my fellow
14 Commissioner, Sharon Brown-Hruska.

15 This is the sixth meeting of the GMAC
16 since its formation in 1998, with the previous five
17 dates under the leadership of our former
18 Commissioner Barbara Holum. Federal law provides
19 the CFTC with the authority to create such
20 advisory committees for the express purpose of
21 seeking public input and advice from the industry
22 we oversee. This is an extremely important

1 exercise for ensuring that the Commission meets its
2 public objectives without unnecessarily hindering
3 the markets.

4 When Chairman Newsome asked me to serve as
5 Chairman of the GMAC, I was honored to take on the
6 challenge. I strongly believe that global
7 competition and regulation will prompt most of the
8 difficult policy debates for years to come. The
9 global economy has unique policy considerations
10 that must be addressed by our markets and
11 regulators. Differences in language, culture,
12 regulation and law, technology, currency, and even
13 time zones make these policy questions even more
14 challenging.

15 The heart of today's agenda will explore
16 two such matters, global clearing and regulatory
17 coordination among nations. The expectations I
18 have for this committee are pretty straightforward.
19 My first goal is simple, but overlooked by many of
20 us in Washington, and that is the art of listening.
21 One of the clear benefits of this expert body
22 is that commissioners and staff get to hear

1 firsthand the complex issues affecting the industry
2 from those on the front line. Allowing the
3 Commission to witness the public discourse on
4 certain issues provides assurances that our
5 decisions will be informed and viewed as legitimate
6 in the eyes of the public.

7 The second goal of the GMAC should be to
8 identify international issues that need additional
9 discussion and to provide the Commission with the
10 appropriate information to make sound policy
11 decisions. If this information gathering stage
12 leads the GMAC to a consensus view, then this group
13 should make clear and succinct recommendations to
14 our Commission. I am hopeful that today's
15 discussion will reveal certain issues where
16 consensus is possible and desirable.

17 My last goal is one that may be difficult
18 to measure, but it's nevertheless just as important
19 as the other goals I have listed. I'm referring to
20 the building of relationships with those affected
21 by our decisions. Trust is still a valuable
22 currency that has great value for us here

1 in Washington, but one that is in constant need of
2 nurturing. I am hopeful that the relationships
3 that I build and that this Commission builds as a
4 result of these meetings will be the foundation
5 upon which good policy decisions can be made.

6 Again, I am pleased to have so many
7 distinguished individuals here serving on the GMAC
8 to help us tackle these weighty policy
9 goals, but before I make introductions, I would ask
10 my fellow Commissioners whether they have any
11 beginning comments.

12 Mr. Chairman.

13 CHAIRMAN NEWSOME: Thank you,
14 Commissioner. Mine will be very short.

15 I wanted to thank each of you for taking
16 time away from your professional roles to advise us
17 on the issues in front of us today and your
18 willingness to serve on this advisory committee.

19 I wanted to pay tribute to Barbara Holum
20 for the able years of service as Chairman of this
21 advisory committee as well as a Commissioner at
22 the CFTC and thank Commissioner Lukken for his

1 willingness to serve as the current Chairman of
2 this committee and for re-establishing the advisory
3 committee, as he has, with each and every one of
4 you. I also want to thank he and his staff and the
5 division heads who assisted in developing this
6 agenda and the program that we're going to hear
7 this afternoon. I think it's an outstanding
8 agenda. Certainly there are a number of important
9 policy issues currently in front of the Commission
10 on this agenda this afternoon.

11 So again, I thank you for your willingness
12 to serve, and, Mr. Chairman, I look forward to
13 listening to the discussion today.

14 COMMISSIONER LUKKEN: Commissioner
15 Brown-Hruska.

16 COMMISSIONER BROWN-HRUSKA: Thank you.
17 It's just a real pleasure to see all these faces
18 here. I said, when I saw the list of those who
19 agreed to serve that Walt had selected, I said it's
20 like a dream team of committee members, some of the
21 smartest, most innovative people I've met and know
22 in this industry since I've come to serve as a

1 Commissioner, and I just want to congratulate you
2 all and thank you in advance for all of your advice
3 and counsel as we go forward and make some of these
4 tough decisions and also to invite you at any time
5 to feel free, not only in the formality of this
6 committee meeting, but as well to feel free to pick
7 up the phone and call us if there are any issues
8 that you want to keep to us apprised of. We really
9 appreciate that side of this industry, that they're
10 always willing to let us know how they feel.

11 And I also want to apologize. I have to
12 go to a speaking engagement out in Scottsdale,
13 Arizona, so I'm catching a flight. So I won't be
14 able to stay for the rest of the meeting, but I
15 certainly will keep track of all that is said and
16 look forward to reading the transcript.

17 So again, thank you very much and have a
18 good meeting.

19 COMMISSIONER LUKKEN: As I mentioned, we
20 have a very impressive group here, and I thought it
21 might be helpful—there are complete biographies of
22 all the participants in our handouts if you want to

1 read about all the unique backgrounds and
2 impressive backgrounds of our participants--but I
3 thought it would be helpful to go around and
4 briefly introduce ourselves. So you know the
5 Commissioners up here, but maybe we'll start with
6 George Crapple to my right. If you wouldn't mind
7 stating your name, your organization, and your
8 responsibilities, and we'll move around the room.

9 MR. CRAPPLE: I'm George Crapple. I'm
10 Co-chairman of the Millburn, Ridgefield, a CTA and
11 CPO.

12 MR. FALK: I'm Harry Falk. I am the CEO
13 and President of NYBOT.

14 MR. DUTTERER: Dennis Dutterer, President
15 and CEO of The Clearing Corporation.

16 MS. MEDERO: Joanne Medero, General
17 Counsel, Barclays Global Investors.

18 MR. DAVIDSON: John P. Davidson. I run
19 institutional operations for Morgan Stanley.

20 MS. PHILIPS: Susan Philips, Dean of the
21 School of Business at George Washington University.

22 MR. LEIGHTON: Roy Leighton. I'm the

1 Chairman of the FOA, the European equivalent of the
2 FIA, but in my other life, I'm also a practitioner
3 and I'm the Chairman of CALYON, which is the merged
4 Credit Lyonnais and Credit Agricole in London.

5 MS. TAYLOR: Kim Taylor, Chicago
6 Mercantile Exchange Clearinghouse.

7 MR. KLEIN: Bob Klein. I'm Associate
8 General Counsel and Director at Citigroup Global
9 Markets, Inc.

10 MR. NANDAPURKAR: Satish Nandapurkar, I'm
11 CEO and President of Eurex U.S.

12 MR. BERLIAND: Richard Berliand with J.P.
13 Morgan. I look after the futures and options
14 business and the prime brokerage business for the
15 firm.

16 MR. COLLINS: I'm Bo Collins, President of
17 NYMEX.

18 MS. LITT: Bonnie Litt, Managing Director
19 and Associate General Counsel at Goldman Sachs.

20 MR. PICKEL: Bob Pickel, the Executive
21 Director and Chief Executive Officer of the
22 International Swaps and Derivatives Association.

1 MR. FILLER: Ron Filler, Managing
2 Director, Lehman Brothers.

3 MR. DAVIS: Kevin Davis, CEO, Man
4 Financial.

5 MR. ROTH: Dan Roth, President of National
6 Futures Association.

7 MR. HAHN: Arthur Hahn, partner in Katten,
8 Muchin, Zavis, Rosenman.

9 MR. DAN: Bernie Dan, President and CEO of
10 the Chicago Board of Trade.

11 MR. COOPER: Adam Cooper. I'm Senior
12 Managing Director and General Counsel of Citadel
13 Investment Group, and today I'm here as Chairman of
14 the Managed Funds Association.

15 MS. ZIEGLER: I'm Emily Ziegler, a partner
16 at Willkie, Farr & Gallagher.

17 MR. McCARTY: Pat McCarty, General
18 Counsel, CFTC.

19 MS. CORCORAN: Andrea Corcoran, Director,
20 Office of International Affairs, CFTC.

21 COMMISSIONER LUKKEN: Before we kick off
22 the discussion, I thought it would be useful to go

1 over a couple of logistical points. In order to
2 make sure that we're getting everybody's comments,
3 if you wouldn't mind, to be recognized, just place
4 your placard on its side and we'll see if we can
5 make sure that we can find you in the room if you
6 have a comment to make. Also, and many of you
7 picked up on this, please turn off your microphone
8 after your comments are made so that there is no
9 distortion involved with the PA system. That's
10 helpful.

11 And also, I guess that's all the issues I
12 need to, as far as logistics, need to talk about.

13 II. REPORT ON ACTIVITIES OF CFTC OFFICE OF
14 INTERNATIONAL AFFAIRS

15 COMMISSIONER LUKKEN: I'd like now to
16 first turn it over to Andrea Corcoran, the head of
17 our Office of International Affairs. We are very
18 fortunate at the CFTC to have Andrea heading up
19 this shop. Her staff as well as herself are
20 representing us before international bodies on a
21 regular basis.

22 I often get to travel with Andrea. Many

1 people don't know this, but Andrea is actually
2 fearful of flying, which makes her job very
3 difficult, but she does it anyway, recently in
4 Aman, Jordan. So good thing we don't have hazard
5 pay, but she makes it, and so we're very thankful
6 for all the hard work she does on behalf of the
7 agency. Certainly the respect that we receive as
8 an agency is largely due to the work that her and
9 her staff do and their dedication.

10 So we thank them, but I thought it would
11 be helpful to show off what we are doing on the
12 international front and to sort of frame many of
13 the issues we're going to talk about, to have her
14 give us an update on what they've been doing out of
15 the international division.

16 MS. CORCORAN: I don't know what's the
17 best way to do this.

18 Thank you very much for those kind words,
19 and it is true that I am afraid of flying, but I
20 always take my vodka with me.

21 [Laughter.]

22 MS. CORCORAN: Actually, Commissioner

1 Lukken asked me to cover three topics. He wanted
2 me to speak about IOSCO, talk some about how the
3 international community is looking at clearing and
4 also address mutual recognition, and I asked him if
5 we had a full afternoon for this and he said no.
6 So we're going to have to blitz through this very
7 quickly.

8 The Office of International Affairs is
9 responsible for several types of activities:
10 Coordinating with foreign regulatory authorities
11 and helping the other operating divisions to do
12 that, participating in regulatory forums at the
13 international level, particularly with respect to
14 standards setting, providing technical assistance
15 to foreign governmental bodies which helps to
16 improve regulation but also helps to make friends
17 around the world that are helpful to us when
18 problems occur, and coordinating policy with other
19 U.S. financial regulatory agencies with an
20 international mission, such as the Department of
21 Treasury and the U.S. SEC. Some of these
22 activities, as you may know, are specifically

1 identified in the CFMA in Section 126, which is the
2 sense of Congress provision that says it's the
3 sense of Congress that the CFTC should have an
4 international dimension, and I know all of you know
5 that futures has long been a very international
6 business.

7 Now, the only way I could cover this
8 agenda of issues that were put to me was to try to
9 put this on a PowerPoint, and I'm not going to read
10 all the slides to you, but--and if you want them
11 sent to you at some point, we can E-mail them to
12 you, but this is to give you a flavor of what's
13 happening, starting with IOSCO.

14 I would just commend the IOSCO website to
15 everyone. There is a lot of fantastic work product
16 that has been done under the auspices of IOSCO.
17 It's not nearly as well known as the work done by
18 the Basel Committee on Banking Supervision, but
19 it's excellent work, and most of it is public and
20 useful to you. The parent committees are the
21 Technical Committee, which is a committee of the
22 most developed countries; the Executive Committee,

1 which is really the political, most political,
2 committee of IOSCO which deals in such issues as
3 funding and what the Secretariat should do and also
4 the overall structure of IOSCO; and the Emerging
5 Markets Committee which is a group of self-selected
6 countries that call themselves emerging markets.
7 At annual meetings, and I was just at an annual
8 meeting in Aman, IOSCO also sits through the
9 President's Committee. The President's Committee
10 is also all the membership of IOSCO. There are
11 more than 174 members of IOSCO.

12 There are various work committees at
13 IOSCO, and the CFTC participates on all of these
14 committees except for Standing Committee One.
15 Probably the most important committee to date has
16 been Standing Committee Two on secondary markets.
17 They have undertaken a lot of initiatives that were
18 sponsored by the CFTC, in particular some of the
19 initiatives that followed the Barings crisis
20 relative to publication of default procedures, and
21 I think those initiatives are relevant because you
22 see them coming back in the proposals for central

1 counterparty clearing that will be the subject of a
2 consultation paper that you may be speaking about
3 today.

4 IOSCO also has some task forces. These
5 task forces have become more and more important.
6 The first ones were constituted right at--on
7 October 10th, right after September 11th, and as
8 you can see, the first one on a multilateral
9 memorandum of understanding and client
10 identification came directly out of the concern of
11 the international community as a whole that there
12 be better capacity to share information and that
13 people who participate in agreements be really able
14 to meet the commitments to share information that
15 they make and also that there should be some
16 international view as to what appropriate types of
17 client identification information should be
18 available to regulators. And you can see the final
19 report, I think, is at the back of the room on
20 client identification.

21 They also have begun to work through what
22 I would call Chairmen's task forces. To date,

1 they've all been led by Roel Campos, who is a
2 Commissioner at the U.S. SEC, and currently-on-
3 the-agenda issues that they're looking at are
4 international securities fraud prompted by the
5 Parmalat case and development of a code of conduct
6 for credit rating agencies, but they have already
7 issued--and these are available on the
8 Web--guidance for sell-side securities analysts and
9 regulation of sell-side security analysts and also
10 guidance or principles for accounting and auditing
11 oversight and independence. I would note that for
12 many, many years IOSCO has talked about the
13 development of accounting standards and have moved
14 toward more international standards.

15 There is also a task force on
16 implementation. This is headed by the CFTC, and
17 its purpose has been to be take the objectives and
18 principles of securities regulation that were
19 approved by the full membership of IOSCO in 1998
20 and develop a methodology for assessing whether or
21 not various jurisdictions can meet those
22 requirements, and the committee also deals in

1 training and self-assessment exercises which are
2 really a form of modified peer review.

3 Some other entities that are of importance
4 that you might be interested in knowing about are
5 the Joint Forum, which is a group that involves
6 banking securities and insurance regulatory
7 authorities. It's chaired by Gay Evans, who many
8 of you may know, and for the first time, the CFTC
9 is participating on a Joint Forum committee with
10 respect to outsourcing. There is also the
11 Committee on Payment and Settlement Systems and
12 IOSCO Committee on Clearing and Settlement and
13 Central Counterparty Issues. They've dealt with
14 some other issues, like short-selling, but the
15 chairs of this committee are the U.S. Fed and
16 Singapore, and the CFTC has participated in their
17 consultative document on clearing. The comments
18 are due June 9th.

19 Many of you may know Mary Schapiro. She
20 is the head of the Consultative Committee of IOSCO.
21 I see we have in the back of the room one of the
22 important heads of the Consultative Committee, Bob

1 Wilmeth, and he put the Consultative Committee on
2 the map. They're still trying to be consulted, but
3 I think they're getting there. I think they will
4 get there eventually.

5 I'm not going to talk about all of this.
6 This shows you very broadly how IOSCO is a
7 standard-setter, fits in this very broad overview
8 of financial institutions that have a role with
9 respect to standards-setting in the regulatory
10 area.

11 What is the current focus of IOSCO? It's
12 not too different from the current focus of the
13 CFTC with respect to international issues,
14 developing agreed high-level standards, high-level
15 being not too specific for the conduct of
16 securities regulation, making information available
17 on different approaches to issues, and encouraging
18 implementation of standards by training, assisted
19 self-assessment, and with respect to multilateral
20 MOU, screening and monitoring exercises. You
21 cannot sign the multilateral MOU unless a group of
22 IOSCO participants have said that you have the

1 right powers and authority to do it, and once you
2 sign it, you're subject to a monitoring committee
3 that monitors whether or not you're actually
4 meeting your commitments to share information.

5 So what's in all of this activity for you?
6 I know many people say, Well, why have regulators
7 talk at this level, and I think the bottom line is
8 really the work of foreign policy is done at a high
9 level, but there is a lot of operational activity
10 that goes on internationally, and so these
11 exercises are intended to improve enforcement,
12 improve the infrastructure in the markets where you
13 do business so you can feel more confident that
14 they're not going to change the rules of the game
15 on you midstream, and also to move toward
16 harmonization and reduction of duplication to
17 permit, in appropriate cases, substantial reliance
18 on home market regulatory regimes where those
19 regimes are adequate.

20 Also, you should get better information on
21 the rules that are in place, a better capacity to
22 identify where you would like to comment on things.

1 I mean, one of the big trends internationally is to
2 make what is happening more transparent and, you
3 know, better capacity for your own authority to
4 help you obtain the kind of access that you need.

5 Now, these are just a list of some of the
6 many types of things that are being discussed by
7 IOSCO. The first one is error trade policies and
8 outsourcing, will be the subject of really surveys
9 to the outside world about what people are doing.
10 The securities issues with respect to Basel are
11 something that we've been invited to do for the
12 first time. The Basel Committee in the past has
13 not been too interested in what securities
14 regulators have to say or securities brokers have
15 to say, and now they have indicated some interest.
16 My own office, in particular Robert Rosenfeld, has
17 been very instrumental in helping a lot of
18 different people get access to markets by providing
19 the information that they need about what the CFTC
20 does. This is a list of some of the jurisdictions
21 in which we've provided that kind of help.

22 Now, I was asked also to discuss mutual

1 recognition, which I would say is a very, very big
2 topic, and with apologies to representatives of the
3 European Union who are here today who no doubt know
4 a lot more about this than I do, I was trying to
5 explain a bit about why perhaps we are a bit late
6 in the running to this game, because this is
7 something that they've been talking about for a
8 long time in Europe. The Treaty of Rome in 1957
9 anticipated a single economic market. *Capital*
10 *Services, Goods and Persons*, in 1983 a court
11 decision, said this really means that we have to pay
12 regard to each other's rules and requirements, and
13 this gives you a bit of a view of the increasing
14 pace of moving toward a single market and
15 developing what amounts to harmonization of those
16 requirement that fundamentally affect the costs of
17 doing business, a sort of, kind of leveling of the
18 playing field. And although when you talk to
19 people from Europe, they're always complaining
20 about how slow this process is, I think you have to
21 really--at least I would say personally as an
22 American, I'm incredibly impressed that they can do

1 all of this with 15 and now 25 countries, and, you
2 know, we've been at this since 1789 with the
3 States, and I don't know that we've made as much
4 progress as they have.

5 At the end of that list that you saw
6 before, you saw that there was CESR, which was the
7 Community of European Securities Regulators.
8 That's their website. They also have a lot of
9 very, very interesting information and something
10 that Americans certainly should be aware of,
11 because they are really evidence that Europe is
12 determined to make a lot of its process much more
13 transparent than it has been in the past. There
14 are opportunities to consult on many issues that
15 they have before them. At the moment, they're
16 working on a number of issues relative to
17 implementation of the new ISD, and they run a group
18 called CESRPOL which deals with enforcement, and
19 they are expected to announce an enhanced
20 cooperation with SEC June 4th, and, I mean, if
21 anyone can cooperate with the SEC, we want to
22 encourage it. That can only be good for us.

1 Right?

2 [Laughter.]

3 MS. CORCORAN: Anyway, so again, what
4 happens as a result of all this work toward a
5 single market, there is a passport that's based on
6 harmonization, notification from an establishment
7 jurisdiction to a host jurisdiction as to who is
8 doing business, an agreement that there will be
9 information sharing for regulatory purposes, a sort
10 of home host concept which draws on old conflicts
11 of law as to who is responsible for what and an
12 expectation of reciprocity. That's mutual
13 recognition. I mean, this is what underpins the
14 passport, and, I mean, this is why when you talk
15 about a remote clearing member in Europe, that's a
16 lot different from talking to another European
17 jurisdiction, from talking about a remote clearing
18 member into the United States, because they have a
19 whole framework that's intended to support that.

20 How do we compare this to Part 30? Well,
21 I mean, we would like to say we are a very, broad--
22 broadminded at the CFTC; that we were thinking

1 about mutual recognition about the same time, 1986,
2 as they were getting serious about it in Europe,
3 that this was not a path that the securities
4 markets chose to go down; that we have recognized
5 foreign-based brokers for remote access to U.S.
6 Customers for foreign products, and it is based on
7 a lot of the same ideas that you see underpin the
8 passport in Europe without a treaty to support it.
9 But it hasn't applied to date to U.S. products
10 except in the limited case or a few limited cases.
11 I cite one of them, because, unlike Europe, we
12 haven't harmonized all the costs of doing business.

13 The only thing I would add in closing is
14 that, you know, the United States has really done a
15 great job marketing regulation, because now
16 everyone is doing it. And so I think that I
17 couldn't overstate the importance of, you know,
18 being as active as you can be in bringing your
19 issues about where more harmonization is desirable
20 or more flexibility is desirable or more
21 cooperation is desirable to the international
22 table. I think people are willing to listen.

1 They're making the process more transparent, and I
2 can assure you that the CFTC and its leadership are
3 willing to help.

4 That's it.

5 COMMISSIONER LUKKEN: Thank you very much,
6 Andrea. Like I said, it's impressive to be with
7 Andrea and travel around the world because she
8 knows everybody and certainly knows the subject
9 matter very well.

10 I think the two points that I wanted to
11 just quickly highlight from her presentation to the
12 group: One is the Memorandum of Understanding, the
13 multilateral Memorandum of Understanding that IOSCO
14 has. This is, of course, the standard that all
15 well-regulated securities regulators should try to
16 meet with the different countries, and the nice
17 thing about this compared to many treaties that
18 exist that are signed and not enforced is it does
19 have an enforcement mechanism. There are
20 independent countries that are assessing this.
21 They're going through to make sure that countries
22 that are a signatory on this document are, indeed,

1 doing what they're saying they're doing and that we
2 can feel confident that capital is flowing across
3 borders into well-regulated countries.

4 So I think that's important to note, that
5 this isn't just purely a piece of paper that people
6 are signing.

7 Secondly, I think you get a pretty good
8 understanding of the different structures that are
9 in place that might help with the suggestions that
10 might come out of this group. If we do feel out of
11 today that we have a view that greater regulatory
12 coordination is needed and we should present a
13 view, well, certainly there's a structure in place
14 or there are resources in place that have been
15 thought through over the years that we might be
16 able to utilize in order to make that view known.
17 So I think that's important.

18 But before we change subjects, I wanted to
19 see if folks have different comments, and I'll
20 recognize Roy Leighton for the first one.

21 MR. LEIGHTON: Thank you. If I can ask
22 Andrea through the Chair, you talked about the

1 announced cooperation, which I think has been
2 announced but not in detail between the SEC
3 and CESR, and given the CFT's image as a nice,
4 user- friendly regulator, wouldn't it be an idea
5 and do you have plans to have a similar cooperation
6 agreement? And I'll just put on slightly more
7 flesh, because under the investment services
8 directive which CESR is putting the level two rules
9 in for, for example, commodities for the first time
10 are sucked into financial-type regulation on a Pan-
11 European basis, and this has very considerable
12 implications for non-financial institutions in the
13 commodity business, and I think it would be very
14 helpful if both sides of the Atlantic were talking
15 about this.

16 MS. CORCORAN: Well, I think that you're
17 absolutely right. We have been speaking to CESR,
18 and you have to understand that because we're so
19 friendly, they're not as interested in us, but that
20 being said, our Chairman has been speaking with the
21 leadership of CESR, and they are working out the
22 details of meeting and making more formal plans to

1 cooperate in the future.

2 COMMISSIONER LUKKEN: Anybody else before
3 we move on?

4 All right. Thank you, Andrea.

5 III. CROSS-BORDER CLEARING AND LINKAGES

6 COMMISSIONER LUKKEN: I think the next
7 issue we're going to talk about is global clearing
8 and linkages, which will probably take up a
9 majority of our meeting, but I've asked the able
10 John Davidson to kick off the meeting by giving an
11 overview of the history of clearing and the
12 different models that exist and also the risks that
13 might be involved with those models.

14 So with that, I'll turn it over to John.

15 MR. DAVIDSON: Well, thank you very much,
16 Commissioner Lukken, Chairman Newsome, Chairman
17 Brown-Hruska, agency staff, and fellow committee
18 members.

19 When Commissioner Lukken asked me to sort
20 of touch on history, clearing models and risks, I
21 decided to sort of limit this to a discussion not
22 of all types of clearing models, but of linked

1 clearing models, and taking the note that there is
2 no history without literature, I take you back to
3 1984. A number of people, particularly in the
4 U.S., viewed the start of cross-border clearing
5 links to something that happened in September of
6 1984 when the so-called mutual offset system
7 between the Chicago Mercantile Exchange and the
8 Singapore International Monetary Exchange, or
9 SIMEX, commenced operation.

10 In fact, cross-border clearing
11 arrangements considerably predate that formal
12 Commission approval of that particular linkage.
13 There are a number of examples one could cite, but
14 the most widely known one is the so-called ICCH or
15 the International Commodities Clearinghouse which
16 at one time provided clearing services for futures
17 markets on five separate continents. There was
18 rotation of senior staff of ICCH among the clearing
19 organizations in different locations. There was
20 some commonality in systems, procedures, and
21 ultimate ownership; however, each clearing
22 membership was distinct and there were no

1 interaffiliate transfers of trades, positions, or
2 collateral. So they were not linked clearing
3 organizations even though they shared certain
4 common services and administrative functions.

5 I would posit that other than a couple of
6 topics that we're going to talk about in more
7 detail later on, there fundamentally are no
8 distinctions between intra- and international
9 clearing linkages outside of questions of
10 insolvency and taxation. So I am not an expert on
11 either of those, although people say listening to
12 me is quite taxing. I am going to treat these as
13 sort of a theoretical case of linkages, and whether
14 they exist within a particular nation and
15 jurisdiction or across borders, it seems to me is
16 not all that relevant to many of the types of risks
17 that they pose.

18 So I'd like to suggest to you that there
19 are, in essence, four models of clearing linkage in
20 practice in the derivatives and securities markets
21 in the world today. The first is what I'll call
22 the Mutual Omnibus Linkage. The second are

1 Settlement Linkages. The third are Horizontal
2 Integration Linkages, and the fourth is simply an
3 expansion of the clearing entity, not really a
4 linkage per se. The oldest and perhaps most common
5 form of linkage is the Mutual Omnibus Linkage where
6 each clearing organization establishes an omnibus
7 account on the books of the other clearing
8 organization, and so they become linked to each
9 other through those accounts, and typically those
10 accounts need to manage their positions, manage
11 their collateral, and manage their mark-to-market
12 or variation settlements in a means very much
13 analogous to what any other clearing member would
14 need to do.

15 Also, to continue the analogy, with
16 omnibus accounts, there are variance with respect
17 to whether the omnibus account is disclosed, as I
18 believe the case of the global clearing link will
19 have, or undisclosed, as is the case with the
20 CME-SIMEX link, that is to say whether the staff of
21 one clearing organization can see all the way
22 through to the individual members of the other

1 clearing organization or whether they are a
2 commingled aggregation and they do not have that
3 transparency as to which of the other clearing
4 organizations' members are putting positions into
5 the link.

6 So as I mentioned, the CME-SIMEX is one
7 variant of that model. That's a variant where
8 there are fungible contracts at both participants.
9 So there are eurodollars and they have identical
10 contract specifications between the SIMEX iteration
11 of that contract and the CME iteration of that
12 contract, and only those fungible products are
13 subject to the link. There are another type, but
14 same idea, same different sort of risks where there
15 are non-fungible contracts or there may be a mix of
16 fungible and non-fungible contracts, so the various
17 cross-margining systems in the U.S. between futures
18 and the Options Clearing Corporation are an example
19 where one side only clears options and one side
20 only clears futures and futures on options, but they
21 are brought together into a single portfolio and
22 the risk of that portfolio is assessed and managed

1 accordingly. Likewise, I would suggest to you that
2 the global clearing link involving the Eurex and
3 The Clearing Corporation is a model similar to
4 that.

5 I am advised that my next bullet point is
6 not technically correct. There is one example of a
7 three-way link, not particularly active. The
8 CME-OCC-NYCC link is actually a three-way link.
9 There are "N" numbers of potential links limited
10 only by the number of clearing organizations that
11 could sit in the same room together and actually
12 sign a contract in terms of how many pieces you
13 could have in these links.

14 The second type of linkage is much more
15 limited, both in duration and to some extent in
16 number of iterations you see around the world, and
17 these are settlement linkages. So these are where
18 one clearing organization will use the facilities
19 of another clearing organization to fulfill the
20 obligations of clearing participants or to arrange
21 for the fulfillment of clearing participants. So,
22 for example, when a U.S. equity option becomes a

1 share or a hundred shares of stock, that actually
2 is affected by a linkage between the Options
3 Clearing Corporation and the National Securities
4 Clearing Corporation, and because there is at least
5 a theoretical possibility that a clearing member
6 will become insolvent during the three days between
7 exercise and actual settlement of the underlying
8 shares, there is a risk-sharing process among those
9 linked organizations.

10 Moving over to Roy's neck of the woods,
11 the link between LCH-Clearnet and CREST for the
12 treatment of the settlement after the central
13 counterparty, LCH-Clearnet gets done with LSE
14 trades, is another example of a settlement linkage
15 between two clearing organizations.

16 The next example is a horizontal
17 integration linkage, and in this case, I think,
18 particularly since Mr. Hardy couldn't join us
19 today, a picture is worth a thousand words.
20 LCH-Clearnet is perhaps the most visible example of
21 horizontal integration linkages, although there are
22 many others, including Eurex, which would--or

1 Deutsche Bourse writ large, which would fall into
2 this example, but LCH-Clearnet, as this
3 illustration from their merger document
4 demonstrates, actually provides central
5 counterparties services for a total of 17 different
6 markets and is linked to at least 12 different
7 clearing organizations.

8 So here they are horizontally providing
9 one of a variety of clearing services, that is the
10 central counterparty clearing service, and in order
11 to facilitate that service, they link upstream to
12 different markets and downstream to different
13 central securities depositories and international
14 central securities depositories.

15 The final type of linkage really isn't a
16 linkage at all, but just to be complete, there are
17 what I would call an expansion-of-entity linkage
18 where fundamentally a clearing organization moves
19 into either different time zones or different
20 geographic locations. So the first example of that
21 in our industry in the U.S. was the old Commodities
22 Clearing Corporation, now part of the New York

1 Commodity Clearing Corporation, expanded its
2 facilities and its operating hours to support FINEX
3 trading in Dublin, Ireland in 1994. So there
4 aren't any additional clearing organizations that
5 intermediate those trades, but there is an
6 expansion of service. Certainly clearing support
7 for the various originally after-hours electronic
8 trading systems were another example of this
9 expansion of services into different periods of
10 time and conceivably different geographic
11 locations.

12 So with that sort of an overview of the
13 sort of more of a theoretical perspective of what
14 the different models are, the question arises what
15 are some of the risks associated with this idea of
16 linking clearing organizations together, and this
17 list is by no means exhaustive and it's also not
18 intended to alarm anyone. I think all of us will
19 agree that the first step in risk management is
20 recognition that risks exist. If you don't
21 understand what risks exist, you can't very well be
22 prepared to manage those risks or to meet the

1 stormy day in which they spring full form from the
2 head of Athena.

3 The first of these types of risks is one
4 that happily is somewhat disappearing from the
5 world scene, but still is tied into things like
6 tying deadlines in the banking system, and that's
7 what I would call asynchronous batch-cycle systems
8 risk. So this type of risk just deals with the
9 fact that many organizations have batch cycles and
10 they need to have an end of day at a particular
11 point in time and they need to run their processes
12 at that end of day and they need to square everyone
13 up at that end of day, and if one of those
14 organizations happens to be in the Asian time zone
15 and another of those organizations happens to be in
16 the Americas time zone, and they're trying to
17 discover what final portions are or they're trying
18 to mark to a particular point in time, a particular
19 price of an instrument at a particular point in
20 time, that's going to be different for both
21 positions and prices than the next point in time in
22 the United States.

1 And that leaves--gives rise to the second
2 form of risk, which is liquidity risk.

3 Now, real-time clearing systems go a long
4 way to moving away from those sorts of
5 batch-oriented imbalances in positions and/or
6 changing situations that can't be fully monitored;
7 however, again, because doing a mark-to-market and
8 moving money requires doing things at a point in
9 time, they will continue to exist, even with some
10 level of real-time clearing systems.

11 Liquidity risk is a significant issue for
12 mutual omnibus linkages of various types, and this
13 simply arises out of the fact that the positions,
14 just like positions for any clearing member, are
15 subject to moving against that clearing member.
16 Positions of the other clearing organization on the
17 books of the particular clearinghouse are subject
18 to moving against that other clearing organization,
19 and there is a cash flow associated with that
20 change in valuation. It is inherently a temporal
21 issue, that is to say things do at expiration come
22 back to zero, and the money does all wash out and

1 balance out, and I can assure you from hours of
2 exercises designed to demonstrate exactly that on T
3 accounts, it does work, although given a portfolio
4 of positions, you can't actually see it go to zero
5 on any particular day. But it is an important
6 issue, and one of the reasons it's an important
7 issue is because the nature of clearing
8 organizations is different than the nature of
9 brokers and dealers or even large users of our
10 markets, and that is to say that clearing
11 organizations, while having relatively liquid
12 balance sheets, do not typically issue debt, have
13 limited access to the credit markets as a result of
14 that choice on their part, and consequently are
15 limited to bank credit lines to fund these sort of
16 temporal open interest and settlement differences.
17 That's not a problem per se. It is an exercise for
18 the management of the linked clearing organizations
19 to figure out the size of the bank lines they need
20 to manage that risk and to have appropriate
21 contingencies for when the market moves in a
22 direction and by an amount larger than what their

1 regular bank lines would have anticipated.

2 Product characteristic mismatch risk is
3 the next type of risk. You can think of it as a
4 subset of basis risk really, and it is a
5 significant issue for mutual omnibus settlement and
6 horizontal integration linkages. So this is just
7 the fact that you have a portfolio of positions in
8 these clearing organizations that are fundamentally
9 different in a number of ways. It's actually not
10 unique to a linked clearing organization. I would
11 argue that the New York Mercantile Exchange
12 Clearinghouse, which to my knowledge is not a
13 participant in a formal link arrangement, has this
14 risk with respect to the different types of
15 products which they are now serving as central
16 counterparty for. You just need to understand that
17 not every product gets marked to market twice a
18 day. Some products are options and don't get
19 marked to market at all, at least in the U.S.
20 System or that is to say don't have mark-to-market
21 settlement variation flows, and you need to
22 understand how these differences in products

1 interface between the two different clearing
2 organizations impact the risk which the clearing
3 organization is managing.

4 You don't even have to have products in
5 separate regulatory jurisdictions to have this
6 issue. The OCC-NSCC link, for example, is plagued
7 by the fact that the OCC being a derivative of the
8 former Board of Trade Clearing Corporation carries
9 positions for customers separately than positions
10 for what we would call house positions, separately
11 from what we would call positions for market
12 makers, whereas the NSCC aggregates all those
13 positions into one commingled pot, and they cannot
14 easily compare collateral requirements on both
15 sides of that arrangement because of those
16 differences in the way all of us, as clearing
17 members, account for our positions with them.

18 Concentration risk is the fourth type of
19 risk that I would bring to your attention. It's
20 probably most significant for horizontal
21 integration linkages. So if you are, in fact,
22 providing central counterparty services for the

1 vast majority of the derivative markets in Europe,
2 you'd better be--and a few of the cash markets in
3 Europe--you'd better be pretty good at providing
4 central counterparty services, because all of the,
5 or at least a substantial number of the European
6 eggs are in your basket, and it's your
7 responsibility to take good care of that basket,
8 again, something I think that the management is
9 well aware of.

10 Finally, contagion risk is significant,
11 particularly for mutual omnibus models, but to some
12 extent for settlement linkages as well, although
13 not for as great a period of time. There is an
14 extent to which linked clearing organizations are
15 only as strong as the default procedures for the
16 least creditworthy clearing organization and the
17 least creditworthy clearing member, that is to say
18 since 1984, a default on the SIMEX has had the
19 potential to impact clearing members on the Chicago
20 Mercantile Exchange. Now, to my knowledge, with
21 one very significant exception whose name starts
22 with a "B", there haven't been any defaults at the

1 SIMEX since 1984, but nonetheless, a clearing
2 member of the Chicago Mercantile Exchange that only
3 traded pork bellies and didn't ever go near a euro-
4 dollar or a euroyen or a Nikkei was still subject
5 to some level of risk of contagion were the default
6 procedures at SIMEX insufficient to handle the
7 insolvency of a clearing member, and the same thing
8 is true for any of these other mutual omnibus
9 linked organizations. There is risk. The risk,
10 absent good risk management procedures and
11 policies, can spread from one clearing organization
12 to another, and that risk is generic, and all
13 clearing members face that risk unless the clearing
14 organization just doesn't mutualize risk at all.
15 All clearing members face that risk as soon as
16 there is a linkage between the participants.

17 So that's my sort of overview of history
18 and models and risks, and I'll be happy to turn it
19 back to Commissioner Lukken for some further
20 discussion.

21 COMMISSIONER LUKKEN: Maybe I'll just ask
22 a question to the group, and I think it's important

1 we get a dialogue going on some of these topics
2 instead of sort of presentation form. But the
3 one I had and the one that's relevant to us is
4 what are the risks that regulators should be
5 interested in, in particular the ones he's listed,
6 but which of the ones, especially on clearing
7 links, should we be focused on? Certainly there
8 are many risks involved here, but in particular for
9 global links, are there some of these that deserve
10 more attention than others? How should we be
11 looking at them? We certainly have organizations
12 in place that can help us garner information and
13 talk to folks.

14 But, Richard, we'll start off with you.

15 MR. BERLIAND: Thank you. Curiously, I
16 need to add an additional risk, which is not
17 perhaps a risk for the market participants, but
18 it's a risk for the regulators themselves, and as
19 the growth of linkages has taken place and, indeed,
20 the amount of trading that takes place across
21 borders has increased, it's the fact that the
22 regulators are increasingly becoming a major factor

1 in the commercial outcome of activity that
2 participants in the markets are involved in. I'll
3 just put out three examples that I jotted down
4 while John was talking just now.

5 The first is that as you move into an
6 LCH-Clearnet environment, we're now getting to the
7 point where users in the market can now choose
8 which regulator will supervise their activity in a
9 particular product. So three to four years from
10 now in Europe, you can decide whether you wish to
11 have your French-listed derivatives activity
12 handled in the U.K. under FSA supervision and rely
13 on the fact that the FSA and the Commission Bancaire
14 will do the necessary behind the scenes
15 in order to make that work smoothly. And very
16 clearly, there is going to be different regulatory
17 environments operating on both sides of the channel
18 which will arise in different decisions, but one
19 could envisage a situation where the entire user
20 community decides to go under FSA supervision and
21 the Commission Bancaire is without any clients, for
22 want of a better word, in a pretty short period of

1 time.

2 So this is at its most obvious where a
3 user in the marketplace is going to be able to
4 select the regulator that looks after a product
5 that is active in a different jurisdiction, and one
6 evidently could be in a similar situation between
7 the Clearing Corporation and Eurex clearing where
8 we will be able to move product back and forth in
9 the way that we do today; but whereas today, it's
10 been limited really just to futures activity such
11 as the MOS between SGX and the CME. This is
12 becoming a far broader and much bigger scale type
13 of selection of regulators, which I think,
14 therefore, is something that, as yourselves, you
15 need to be very aware of the commercial impact of
16 what we are doing here. It's no longer a niche
17 activity that's just a bit of futures. It's across
18 a whole scale of different activities.

19 The second I would say is that not only
20 the participants in the markets themselves can
21 select the regulator, but the clients of the
22 participants in the market are able to select the

1 regulators. Now, at the moment, under a Part 30
2 exemption, you cannot have a domestic U.S.
3 Customer sign up with a non-U.S. entity to trade
4 U.S. markets, but the fact remains that you
5 certainly can have a client sitting in the U.S.
6 Deciding whether they wish to have their European
7 activity handled under U.S. or under European
8 regulatory environments, and certainly I will speak
9 for my own shop and say that we very, very much do
10 have clients select the legal entity based upon the
11 environment in which they're working.

12 Now the most obvious by far, and I'm not
13 suggesting this be an action point here or
14 otherwise we will be frustrated by inability to
15 solve the problem, but at its most obvious is the
16 fact that in Europe, you can hold futures and
17 securities in the same account, which quite clearly
18 we are not able to do here in the U.S., something
19 that our clients would very much like to do, and I
20 think all of us fully understand the implications
21 of trying to embark on that as a life activity
22 could easily end up in a frustrated life, but

1 nonetheless, it's a perfect example of where we
2 have significant numbers of clients selecting to
3 sign up offshore to trade offshore markets when in
4 reality it should be on done onshore. This has
5 direct impact on U.S. Tax dollars, and as a
6 result, the regulatory environment is driving tax
7 dollars into different regimes.

8 The final thing I would say, and this
9 clearly is writ very large in the current
10 environment, is where regulators are being used as
11 a blocking tactic in a commercial battle that is
12 going on, the most obvious being the current field
13 that exists between Eurex U.S. and the Board of
14 Trade and between Life and the Chicago Merc on the
15 two products that are there, and it is raising the
16 stakes very significantly and is putting regulators
17 in a position where there are implicit in whatever
18 decision they make a very, very large commercial
19 considerations for organizations that they are
20 responsible for regulating.

21 So I just wanted to add, I think, this
22 other risk that perhaps is not so much for the

1 participants, but for the regulators themselves,
2 and I think it is something that has existed for a
3 long time, has not been large because we're really
4 talking about niche players, but I think as we look
5 at LCH-Clearnet and certainly watching some of the
6 tension even within Europe on the regulators trying
7 to sort out their activity there, is it is
8 something we should be very conscious of as we
9 forge down this route. Personally, I'm strongly in
10 favor of these linkages, but I think we need to do
11 it, as you say, John, with our eyes open,
12 understanding the risks.

13 So I just wanted to raise that point on
14 the table.

15 COMMISSIONER LUKKEN: Kevin.

16 MR. DAVIS: First of all, I want to thank
17 John for a fascinating presentation. I want to
18 touch on one of the points you raise, which was the
19 increasing occurrence of futures exchanges clearing
20 OTC products, and I think one of the things that
21 worries me most about that is the point that you
22 make about the mark-to-market issues and in some

1 cases whether you can even mark some of this stuff
2 to market accurately, whether you find that the
3 clients who you are clearing are themselves
4 controlling the proceeds by which that mark to
5 market takes place. And one of the things concerns
6 me is that people often think, well, a central
7 clearing counterparties are fabulous because that
8 means we can trade with each other, but don't have
9 to worry about each other's names, there is a
10 central clear in the middle. What they forget is
11 that somebody else has basically assumed that
12 responsibility and liability, and I am concerned
13 that some other members of the futures communities
14 who start to clear some of these products aren't
15 fully aware of the risks involved in some of those
16 products and whether or not they really understand
17 the liquidation risks, most particularly the
18 concentration risks.

19 I think that before any more of these
20 OTC-cleared products come on stream or if there is
21 going to be an avalanche of them, and if feels like
22 that's about to happen, we really need to look very

1 carefully at whether the futures companies who now
2 find themselves clearing products they have never
3 had anything to do with, have very limited
4 knowledge of, whether they really understand the
5 risks involved in those products.

6 COMMISSIONER LUKKEN: I'll just make one
7 comment on that. As part of the CFMA, a large
8 portion of the CFMA legislation we passed in 2000,
9 the President's Working Group made the
10 recommendation that Congress adopt laws that
11 allowed people to clear over-the-counter products.
12 I think this was done with some caveats, that,
13 indeed, these products should be ones that could be
14 valued and ones that in some ways are commoditized.
15 But you're right. I think you point out the
16 problems with clearing over-the-counter
17 derivatives, and they're things that we definitely
18 look at when we approve those types of
19 transactions.

20 Anybody else have anything? Any other
21 risks that we should be focusing in on here?

22 Bob.

1 MR. PICKEL: Yes. I guess I was just
2 going to respond to Kevin's comments. I think that
3 there is finally some ability to utilize clearing
4 mechanisms for OTC products. It's been talked
5 about since the early days of ISDA. I think,
6 however, it's still viewed as, you know, fairly
7 narrow in terms of its utility, and one of the
8 issues, of course, is the fact that you need to
9 have--the beauty of the OTC product is its ability
10 to tailor terms, and in order to clear, you've got
11 to have some fairly standardized transactions that
12 you can use. I think that still is--that's going
13 to be a limitation for a long time, although I
14 think people will continue to look at ways in which
15 they can use clearing in the OTC context.

16 COMMISSIONER LUKKEN: I'll recognize Kim
17 Taylor from CME, and then, Roy, we'll go next with
18 you.

19 MS. TAYLOR: We're asking for some other
20 risks that we might want to look at, and John did
21 mention the contagion risk in some sense, but I
22 think maybe we want to also consider the

1 lead-through of that type of risk to the ultimate
2 end client, the client protection differences and
3 the bankruptcy jurisdiction differences that might
4 be inherent in different linkages between different
5 jurisdictions.

6 COMMISSIONER LUKKEN: In a moment, we'll
7 turn it over to Art, who is going to walk us
8 through some of the bankruptcy issues and some of
9 the tax issues. So we'll get to that. That's
10 certainly a big issue that we have to tackle.

11 Roy.

12 MR. LEIGHTON: I just wanted to comment on
13 the list of risks which John set out, which I think
14 were a very fair description of what the hazards
15 are, and say if I had to prioritize amongst these
16 in my experience of this business, with the spectre
17 of systemic failure, I think the liquidity risk is
18 the absolute top priority, because if you think
19 back to what happened with Barings in Singapore,
20 it's not quite cross-border clearing, but the vast
21 majority of the people holding the big positions in
22 that market were other Europeans or U.S., and the

1 Singapore authorities called--I've forgotten what
2 percentage of the nominal value of contracts, but
3 they called on a Monday morning for something like
4 60 or 70 percent of the nominal value in margin to
5 be deposited. Well, try to find your banker on a
6 Sunday evening in London and a Sunday afternoon in
7 the United States, and thankfully the authorized
8 bankers paid on behalf of the members and were
9 subsequently competed (sic) by the banking
10 authorities for reckless banking, but if they had
11 not paid, there would have been a giant potential
12 systemic failure.

13 And if you go back to '74--there are not
14 many people probably in the room who remember '74.
15 We had a similar issue between Paris and London on
16 sugar contracts where there was an arbitrage
17 between white sugar in French francs in Paris and
18 raw sugar in British pounds in London. ICCH was,
19 in fact, if I remember correctly, the clearer in
20 both cases. One market had an absolute limit move,
21 30 pounds or something. The other had ten percent
22 of the previous close, and they got completely out

1 of sync, and inevitably they paid out profits on
2 the French side and found it quite difficult to get
3 them back as the two markets balanced out.

4 So I do think from a regulator's point of
5 view, to keep orderly markets, the liquidity is an
6 absolute top priority.

7 COMMISSIONER LUKKEN: Is that an issue
8 more for central bankers--Susan, you may have some
9 comments on that--or is that something that the
10 CFTC can somehow contribute value to?

11 MS. PHILIPS: In fact, I was just thinking
12 about currency risk as we were going around and the
13 Herstatt risk problems. I do think that that's
14 something that it would be helpful if CFTC--and I'm
15 sure you probably are working with some folks at
16 the Fed. They have a very large and active
17 payments system committee and there is a huge
18 network around the world, and they do deal with a
19 lot of these issues, and I'd urge you perhaps to
20 engage some of those staff. Pat Parkinson could
21 put you in touch with the right folks over there.

22 But there is a big committee that

1 works through Basel also on payment system
2 issues.

3 COMMISSIONER LUKKEN: Harry, do you have a
4 comment?

5 MR. FALK: I just wanted to comment that I
6 was there in 1974. I was in the sugar business.
7 And actually, the problem that occurred in Paris
8 was there was a fellow by the name of Natasse,
9 a Brazilian, who had a short position
10 and read the rules and found out that if he didn't
11 buy back his short position, that he would be
12 liquidated at an average of a 15-day period, and
13 the market was moving limit up every day for that
14 15-day period, and he just said I'm not paying my
15 margins; I'll default, and that was really what
16 happened.

17 But I think the London clearinghouse did
18 very, very well, as did the New York
19 Clearinghouse in handling that market. That by far
20 and away, except for maybe soybeans at one time,
21 was probably the most potentially damaging market
22 ever. I mean, you're talking--in 1974, you were

1 talking 30 or 40 million dollars from a company
2 being put up in New York and having to pay it out
3 in London where you had an arbitrage position. And
4 I think that was one of the systemic risks that
5 existed, that somehow or other you were getting
6 your money in New York, but you couldn't get it
7 into London fast enough or vice versa; and that's
8 one of the problems with these things, is can you
9 move it fast enough. I mean, the world is better
10 now, but it wasn't then.

11 COMMISSIONER LUKKEN: Dan.

12 MR. ROTH: Yes. As I was thinking about
13 Richard's comments on regulatory risk, it's a
14 variant of those risks and a risk regulators face.
15 The last place any regulator wants to be is where
16 you have the responsibility to oversee a particular
17 action or activity without the authority to do so
18 effectively, and that's a no man's land to be in
19 and that's why I think it's so important on any of
20 the clearing links to make sure that the regulators
21 have the information-sharing agreements in place
22 that will make sure that they can get the

1 information they need so that in a crisis
2 situation, they can discharge their
3 responsibilities. And it's making sure that you
4 can get the right information in the right way and
5 at the right time, and I think that's a real
6 regulatory risk that if it's not covered, it puts
7 the regulators in an untenable position.

8 COMMISSIONER LUKKEN: Anybody else? This
9 might be a good segue into our next topic. I've
10 asked Art Hahn to talk on bankruptcy issues. He
11 complained that I had given him death and taxes.
12 So this is the death part, I guess. I guess this
13 is the bankruptcy issue.

14 So, Art, if you can lead us through that,
15 I would appreciate it.

16 MR. HAHN: Thank you, Commissioner,
17 Lukken. You stole my opening joke. So I'll have
18 go right into the muck of it as I get going.

19 I think on the bankruptcy issues, much the
20 same way John postured it, there is a risk. I
21 think everybody needs to understand it, and at the
22 end of days, it is not a fully solvable risk. It's

1 there. That doesn't mean that we shouldn't engage
2 in cross-border commerce. The risk is heightened
3 by engaging in that kind of commerce. The trick is
4 to understand it fully and to manage it, but there
5 is, indeed, a risk, and at the end of the day, it's
6 not a completely solvable risk.

7 Clearinghouses, as we're all aware, have
8 become very competitive with one another,
9 competitive for exchanges to clear with them. The
10 ways that they compete are to have a broad
11 membership and to have diverse positions and
12 products that they trade. This offers stability,
13 but it also offers the opportunity for margin
14 offset, which has come to be the currency of this
15 competition: You know, where I can clear that I
16 can make the most effective use of my dollars? And
17 that competition has led certainly to some domestic
18 competition, witness the Board of Trade clearing at
19 the Merc where they are able to enjoy good margin
20 offset, but it's also led to international
21 competition.

22 So you see the CME clearing for MEF. You

1 see LCH coming into the United States and offering
2 the ability of margin offset against the whole
3 panoply of European products that it clears, and
4 we're obviously beginning to look at what Eurex is
5 proposing in terms of very exciting potentials for
6 margin offset.

7 All right. Embedded in that, once you go
8 global, and organizations are different
9 jurisdictions and money is held in jurisdictions,
10 is you come up with location risk in that the
11 bankruptcy codes in different jurisdictions,
12 although in many cases are extraordinarily
13 similar--and don't lose sight of that. You know,
14 the basic schemes of bankruptcy protection are
15 very, very much alike around the globe. They are,
16 however, somewhat different, and those differences
17 can drive some very serious results that results
18 that can ultimately tie into Kimberly's point
19 earlier about, you know, what does the ultimate
20 customer under a particular regime end up in the
21 same place, and, indeed, those are very, you know,
22 fair questions to ask.

1 Let me kind of highlight that a little
2 bit. The basic question in bankruptcy is what is
3 the order of claimant on what's left in the pot.
4 There's going to be a little bit of money left.
5 Everybody gets says give it to me. Do you share?
6 Does Walt get his money before I get mine? What's
7 the rules of the game? That's what the bankruptcy
8 fight is about.

9 Let me give you some examples. This is
10 obviously very simplistic, but the U.S. model for
11 commodities says we have U.S. segregation. It is a
12 single pool. It's isolated from other
13 responsibilities, and in the pool, you share
14 pari-pursuit. So everybody in the pool is equal.
15 Okay. You've got a separate pool--interesting
16 question coming up--for transactions that are a
17 secured amount, that's secure foreign exchanges:
18 Should they be commingled? Shouldn't they? An
19 open question the Commission is going to be
20 wrestling with, but that is, itself, a discrete
21 pool.

22 And then putting the Griffin ruling aside

1 for a moment, the CFTC 190 regime would say if
2 there is a shortfall in one of those pools, the
3 brokerage firm has to top it up, and that topping
4 up is a first claim on the assets of the brokerage
5 firm. It comes before landlords. It comes before
6 employees. It even comes before legal fees. It's
7 very, very important that you, you know, pay these
8 customers and save money first. That's the U.S.
9 model.

10 So now let's go to the United Kingdom, and
11 it's not a very different regime except there are
12 some nuanced differences. For example, take the
13 seg pool. The definitions of what is a customer
14 and what goes in the pool are somewhat different.
15 They have a particular nuanced rule that says if
16 you have a specifically identified asset, a bond,
17 that you put up as security, and if you jump
18 through all kinds of hoops, you put the right
19 charges on it, you sign the right pieces of paper,
20 in the event of a failure, you get that bond back a
21 hundred cents on the dollar. Okay? That's very
22 different than the U.S. rule which says if that

1 bond is in seg, in U.S. seg, if you want it back,
2 you can have it back, but you have to put a hundred
3 cents on the dollar of cash in. Okay? And in the
4 event of a shortfall in seg, you get very different
5 results, and, indeed, that actually is one of the
6 elements of the Griffin case where there was a bond
7 that came out of client money in the U.K. a hundred
8 cents on the dollar, leaving a shortfall. So you
9 get different results. A lot of foreign
10 jurisdictions don't have the equivalent of the
11 top-up regs.

12 So now you get foreign clearing
13 organizations coming to the CFTC and saying we want
14 to engage in the kinds of links that John Davidson
15 described, and the question is should you or
16 shouldn't you allow that. How do you deal with the
17 mismatches between the U.S. bankruptcy results and
18 the results in other jurisdictions? The first
19 exercise is that you need to identify those
20 mismatches, and it is a not-simple task. There is
21 a lot of subtlety to it. This is something I know
22 the staff of the CFTC has spent a huge amount of

1 time paying very close attention to. They have
2 become expert on it, but you must go through that
3 exercise. You must do it with each and every
4 jurisdiction which is different. Okay?

5 Secondly, you've got to--once you conclude
6 that you can get to a match of some sort, you'll be
7 left with out-trades, you know, how do we solve
8 these problems where there isn't a match and we're
9 uncomfortable. I'll give you example of how you
10 solved that problem, was this issue, for example,
11 of specifically identifiable assets. LCH, a U.K.
12 clearinghouse came into the United States, said it
13 wanted to hold U.S. seg. So the question is how
14 would this U.K. rule of specifically identified
15 asset play through the system. Answer: CFTC
16 required LCH, as a condition of granting it its
17 license, that it have special default rules around
18 the holding of these bonds, and to the extent that
19 the bond was in U.S. seg, it simply said you are
20 will write a rule that says you must liquidate the
21 bond or give us cash if you want the bond out, to
22 match the U.S. rule.

1 All right. So LCH created a special
2 default rule to harmonize with the U.S. approach,
3 but that's not the end of the inquiry. You then
4 have to say, okay, will that LCH rule be
5 enforceable in British courts. Okay? And so you
6 had to go through a BAN analysis to determine
7 whether a U.K. court faced with a special provision
8 of a U.K. company would enforce that special
9 provision, and the answer came out to be yes. And
10 that's a long process that the CFTC goes through in
11 deciding whether or not a foreign clearinghouse can
12 do business in the United States, hold U.S. seg and
13 do other things in it. That's just an example of
14 how it happens.

15 At the end of the day, however, you do not
16 come up with a perfect match, and you can have
17 issues that will come out in a bankruptcy court.
18 In the first instance, there is a good chance that
19 bankruptcy courts in differing jurisdictions will
20 follow the rule, you know, the contract of the
21 parties to the members of the clearinghouse, the
22 rules of the clearing organization, but they don't

1 necessarily have to. You can look to comity
2 between countries where they will honor each
3 other's rules, and they often do. You can look to
4 what are called protocols where the different
5 bankruptcy courts and the different people
6 petitioning will come together and say, look, we've
7 got a big mess here; we've got three different
8 jurisdictions; we've got assets in all of them;
9 we've got claimants all over the lots; we've got
10 mismatches of rules; what do we do? The answer is
11 courts sort that stuff out pursuant to protocols
12 where they have special agreements for particular
13 bankruptcies.

14 A good example of that was when the
15 Maxwell publishing empire went under, leaving
16 assets in the United States and in London and
17 around the world, the courts and practitioners got
18 together and said we're going to use U.S. rules for
19 this purpose and U.K. rules for that purpose; you
20 can get it solved. Be aware that after you go
21 through all of those steps, and they generally
22 work, at the end of the day, one of the questions

1 you will always ask is where is the money, because
2 at the end of the day, as Andrea is fond of
3 pointing out, possession is nine-tenths of the law,
4 and you can have all the protocols and everything
5 else. If a particular bankruptcy jurisdiction
6 wants to assert authority over an asset in its
7 jurisdiction, there is a real good chance it's
8 going to be able to do so.

9 All right. So that is the embedded risk
10 once you go global. My thought is that the kind of
11 process that the CFTC has gone through to date is a
12 critically important one. It needs to happen with
13 each and every application carefully, as it's been
14 doing. You don't have to have exact symmetry.
15 There's ways of accepting levels of mismatch.
16 There's ways of dealing with the mismatch, but you
17 have to go through the exercise. I would remind
18 the Commission--and they know it because they put
19 it in all the rules. Whenever they grant an
20 authority, there's an obligation on someone if
21 there is a change to notify the Commission. This
22 is critically important in a bankruptcy context,

1 because these laws are changing in these
2 jurisdictions all the time. The analysis is
3 multifactored, so, you know, picking up on one of
4 the points that was made earlier, if all of a
5 sudden, you've got swaps inside of a clearinghouse,
6 you may have a different bankruptcy regime that
7 applies to a swap as opposed to an exchange-traded
8 future, and that changes the whole analysis.

9 So there is a challenge that once these
10 permissions are granted and these links go in
11 place, that you constantly stay on top of the
12 evolution of either law or products and how it's
13 happening. By and large, the systems that we've
14 had to date have worked pretty well. That's kind
15 of the bankruptcy presentation.

16 I wanted, though, at the end, and I had
17 talked about this a little bit with Commissioner
18 Lukken, and this is maybe a personal observation,
19 but maybe it's worth talking about and as a
20 supplement to the bankruptcy risk analysis, not
21 quite as long as Roy, but just about. I've seen a
22 lot of fails over the years, whether it was the '87

1 crash, whether it was the Eastern European debt
2 crises, whether it was 9-11. I've watched those
3 events from mostly a U.S. perspective, and the
4 thing that I observed is that when there was a real
5 problem, people didn't come to the lawyers and they
6 didn't deal with the bankruptcy codes. What
7 happened was senior regulators, often from the Fed,
8 senior exchange officials, senior clearinghouse
9 officials, and senior brokerage officials got
10 together in a room and tended to sort it. They did
11 so not necessarily with reference to bankruptcy
12 rules. They did it with a gut concern for the
13 markets, and it has worked pretty well in the
14 United States.

15 I remember in the old days when a small
16 Merc clearing firm got into trouble. The way they
17 dealt with it was they transferred the positions
18 out. They transferred the money with it, and
19 everybody kind of banded together and said if the
20 house we transfer it to gets stuck, we'll make them
21 whole, and it was done in 24 hours. The customers
22 were protected. It got done.

1 I remember personally during 9-11, my
2 phone rang with a number of clients who were very
3 concerned about Cantor. You know, nobody knew what
4 was going to happen to them. What happened was a
5 bunch of the senior people at the major houses got
6 together and they didn't talk about the
7 technicalities of the default provisions that they
8 could have claimed in their swaps with Cantor.
9 They decided the interest of the market was to keep
10 the thing alive and not call defaults. There's a
11 lot of examples of that, certainly, the '87 crash
12 and the role of the Fed in keeping everything
13 afloat during that period.

14 I guess my thought is that as global
15 clearing expands, I would love to see that same
16 first step, which is a non-legal step, take place.
17 I would like to see regulators, exchanges,
18 clearinghouses, major participants have a way of
19 dealing with problems as they come up, because they
20 will surely come up, and at the end of the day, a
21 formal bankruptcy proceeding isn't very
22 satisfactory. It certainly isn't in the interest

1 of the futures markets which need to have their
2 problem solved very quickly and justice takes a
3 little too long.

4 So I was trying to think of how to do
5 that, and I'm not certain. I think there's a lot
6 of different ways that one might approach it, but
7 one thing that I think this committee might explore
8 is a mechanism for all of the people in John
9 Davidson's daisy chain of linked clearing
10 organizations, of exchanges, of potential
11 regulators or maybe at least to start just the CFTC
12 as the regulator, and market participants knowing
13 each other, having the ability to go in that room
14 when the bomb goes off and have some confidence in
15 who they're talking with across the table and try
16 to take actions in the interest of the marketplace.
17 At a minimum, it's who are we. Beyond that, I
18 think there could be regular forums where you
19 identify the risks that are, in fact, embedded in
20 the clearing process and talk to one another, how
21 will we solve that risk.

22 I remember the Barings experience. On an

1 international level, it was not handled as
2 elegantly as domestic U.S. similar circumstances
3 were. There was not good communication. There was
4 time zone. There was language. There were people
5 who didn't know each other. People did look for
6 their personal interests. They had a little
7 trouble focusing on the overall interest of the
8 marketplace. Now, that was--in post-Barings, you
9 had the user accords. You had steps in the right
10 direction, but as we expand global clearing, I
11 would like to look for some kind of mechanism where
12 that kind of communication at a minimum can take
13 place. The people can know who they are. We can
14 anticipate at least in broad stroke some of the
15 issues that might come up. I think it would make
16 us safer if you could put a human element to it in
17 addition to the legal element.

18 So that's a thought.

19 COMMISSIONER LUKKEN: Art, thank you for
20 going through not only the bankruptcy, but the
21 comments at the end. I thought that was very
22 helpful.

1 You've been through this clearing review
2 process with us, and you know firsthand how
3 seriously we take our responsibilities. Andy
4 Morton with the Senate Ag Committee is here, and he
5 wants to hear how seriously we take these
6 responsibilities on behalf of our reauthorizing
7 committee, but this is a committee to advise the
8 Commission, and I want to put you on the spot just
9 a little bit since you've been through that review
10 process. In thinking back through that process,
11 what would you consider good and bad in terms of
12 how we approached it, the things that we looked at
13 and felt were important as we went through that
14 whole process?

15 MR. HAHN: I think net-net, it was a very
16 good process. People on both sides of it took it
17 very seriously. No one was shooting from the hip.
18 Everybody understood. There was no finessing of
19 stuff. On both sides, the difficult issues were
20 surfaced promptly, and people dealt with them. I
21 think that was the key to getting it done. You
22 know, people acknowledged this is a problem, how do

1 we solve this problem, and put it all out front.
2 So I thought it was a very good, very healthy
3 process. I think what came out was a considered
4 decision and judgment. I'm not aware after the
5 fact or any other time of issues that were missed.
6 I think everything was considered.

7 I don't think there's anything bad, but I
8 think it is the case that the Commission will have
9 to invest in staff time and knowledge to maintain a
10 permanent repository of these bankruptcy issues and
11 of the shifting issues that are going to be
12 involved. One of the challenges I think you have
13 is that--I lived through this process twice now,
14 once when SwapClear came through several years ago
15 and then most recently. There may not have been
16 attention to the issues in the interim. There were
17 some law changes. There were some other
18 modifications. I think for the Commission, it will
19 be a permanent challenge to stay on top of that and
20 to be looking back at the rules and regulations
21 that have been promulgated and see whether they
22 match up with the new environment, because at the

1 end of the day, what the industry needs from the
2 Commission is the integrity of the markets. That's
3 how all of us non-commission people make their
4 living, and that's because these markets have an
5 awful lot of integrity and they work, and what I
6 would like to see the Commission do is invest in,
7 on an ongoing basis, maintaining that body of
8 knowledge, and it's a complicated one.

9 So that's a thought.

10 COMMISSIONER LUKKEN: Bernie?

11 MR. DAN: Thanks, Commissioner Lukken.

12 I've just got a couple of points to add to Art. I
13 thought, first off, his recap was excellent. In
14 recognizing that the U.S. bankruptcy laws do
15 distinguish between domestic and foreign futures
16 products, I think it is important as these
17 mismatches get defined and get solved and to the
18 extent there are any gaps, is that as a public
19 policy disclosure to clients and acknowledgment by
20 those clients, I think it is extremely important to
21 know the risks that they're entering into; and
22 while that might sound cumbersome for those that

1 might be involved in some of either international
2 or global links, the reality is part of what the
3 Commission has to do is to form policies that
4 withstand for U.S. investors, and part of it is
5 just acknowledging those risks.

6 And so I think I totally I agree with Art.
7 There's never going to be perfect, you know, all
8 the mismatches are not going to be perfectly
9 defined, but we do have a duty and an obligation to
10 inform those of what those risks are.

11 Thank you.

12 COMMISSIONER LUKKEN: Adam.

13 MR. COOPER: Thank you, Commissioner. I
14 was very taken by Arthur's comments.

15 They were very reinforcing, but they're
16 also deeply troubling, because users of the markets
17 want certainty and stability. I think one of the
18 goals we can't lose sight of here is the need to
19 create certainty, to reinforce and facilitate
20 competition which enhances price discovery,
21 transparency, and liquidity. So while, again, I'm
22 taken with the comments and it is important to

1 always have the dialogue, we can't lose sight of
2 the need for certainty, because that will
3 facilitate competition and liquidity within the
4 marketplace.

5 COMMISSIONER LUKKEN: That certainly goes
6 back to Andrea's comments about standard setting in
7 this area and whether we can get everybody up to
8 the same level as far as bankruptcy laws and
9 make sure that--you know, Art had mentioned that
10 everybody is relatively close as far as their
11 different nuances and different bankruptcy laws,
12 but certainly there are nations that don't meet
13 standards that we need to encourage to meet those
14 standards, and you get back to Richard's point. We
15 don't want markets picking jurisdictions because of
16 certain bankruptcy loopholes that they're able to
17 take advantage of.

18 So are there any more comments as far as
19 the bankruptcy issue?

20 Joanne.

21 MS. MEDERO: I just wanted to mention, to
22 take a little bit more on what Art was saying, is

1 that I agree that a calm fraternity, so to speak,
2 in the clearing links is important. I also think
3 an uninformed end user can also wreak havoc in
4 seeking perhaps a legal solution, because they feel
5 they need to, and it actually ties a little into
6 what Bernie is saying, is that information--and I
7 think one of the things in Barings, and I was not
8 in my current position then, was how little
9 information people had about how things worked, and
10 things are even more complex today, and that's a
11 role perhaps the CFTC--because it does gather a lot
12 of this information, is being able to promugate to
13 people quickly in a crisis how something works so
14 they need not go running to the court in such and
15 such a jurisdiction to try to take possession and
16 unwind accidentally something that it may also be
17 working on within the industry.

18 COMMISSIONER LUKKEN: Our general counsel,
19 Patrick.

20 MR. McCARTY: Yes. I'm kind of struck by
21 these comments, because I kind of think at the end
22 of the day when the regulators get together and the

1 representatives of the exchanges and the firms and
2 they try to come up with rough justice, it's
3 inevitable that the losers are going to resort to
4 the courts. To the extent that someone is down a
5 hundred million dollars, two hundred million
6 dollars, or more, it's inevitable, and I think
7 that's the kind of thing where while people may
8 have good intentions, I see it as almost something
9 which we can predict today, and it will occur and
10 the question is just when.

11 MR. HAHN: Pat, at one level, no one can
12 quarrel with what you've just said. Certainly we
13 live in a litigious society and people do look at
14 that hundred million dollar loss and say how can I
15 get that back, and I think that can happen. But I
16 would parse it out a little bit. I think you can
17 do huge good for the marketplace if you have a
18 crisp, coordinated response to a crisis, albeit
19 that after that response, you may still have a
20 lawsuit over the odd hundred million dollars; but
21 just as an example, I go back to Barings. One of
22 the subsidiary issues in Barings was that U.S.

1 FCMs who had money in Asia couldn't get their hands
2 on the money, and all of a sudden, three days or
3 five days--I forget what the magic number was--went
4 by, and they didn't have the number, and the CFTC
5 rule in those days, which got waived, was that
6 you're undercapitalized or you have to take a
7 capital hit for money you can't get your hands on.

8 All right. That's just the U.S., one
9 person looking at one issue. That same issue could
10 be embedded globally now. Okay? Are you going to
11 let the French make their judgment that these
12 forums are undercapitalized because they couldn't
13 get it? Are the English going to decide the same
14 way? How do counterparties really feel about that?
15 Okay? Getting your hands around that kind of issue
16 in a prompt forum as I'm talking about could have
17 huge value to integrity of the marketplace. You
18 can have an issue afterwards. Your hundred million
19 dollar lawsuit may well happen.

20 It's also the case that in some of these
21 events, whether it was 9-11, whether it was the '87
22 crash, some of those things, I am very surprised at

1 the paucity of lawsuits. Yes, you know, there were
2 some certainly in Griffin where, you know, they at
3 least brought their case. The number of people who
4 just went about their business, particularly some
5 of the big, traditional participants in the market,
6 are, you know, held to the compromises. So I think
7 there's some value to it, although albeit I
8 certainly can't quarrel with your issue.

9 COMMISSIONER LUKKEN: Ron.

10 MR. FILLER: Thank you, Commissioner
11 Lukken.

12 I come from the view of, I guess I'm more
13 old school, although I think many of us at this
14 table come from that same approach, and I think so
15 much of what regulation does, either by the CFTC or
16 NFA or the exchanges or whatever, focus a lot of
17 their time and attention on trade practices from
18 the point of view of what's customer protection,
19 and that should be because that's probably where
20 the greatest potential of risk is in our business.
21 But from a macro versus a micro approach, to me, I
22 think many of us here also share that the biggest

1 fear we have is a default, because a default of any
2 kind, of any consequence, impacts the integrity of
3 our markets, and I think one of the most important
4 things we in this committee or the CFTC as a
5 regulator can do is try to--you can never prevent
6 it, but try to minimize the impact of a default.

7 Art mentioned the need to look at various
8 bankruptcy rules among the global jurisdictions,
9 and one of the items he addressed was the concept
10 of this specifically identifiable property. I
11 think that is one concept that distinguishes U.S.
12 bankruptcy laws impacting the futures markets
13 versus any other jurisdiction, and that provides to
14 me the greatest protections to the end user,
15 because most ends users in the event of a
16 bankruptcy are going to be innocent bystanders.
17 One client or whatever is going to cause the result
18 of the bankruptcy of that respective clearing firm,
19 and the need to have or not have the specifically
20 identifiable property is something that maybe this
21 group or the Commission should study and the need
22 to try to modify that rule, because clients today

1 give us various forms of collateral today versus
2 cash, and all of the collateral could easily be
3 deemed specifically identifiable property unless
4 you had an exception to that for purposes of the
5 bankruptcy code.

6 So one of the things we might want to
7 focus on is that concept, how good or better or
8 worse the concept of specifically identifiable
9 property might be as we do this--if we do a global
10 bankruptcy type study.

11 The other thing I would just throw out for
12 further review that hasn't yet been mentioned is in
13 the event of a default, and God forbid it happens,
14 but Barings is the most important example, is
15 looking at the default procedures at all the
16 clearinghouses. If I recall, after Barings, there
17 was a task study and there was an analysis done of
18 all the various default procedures at the
19 clearinghouses globally. The intent was to show
20 that there were a lot of differences, very stark
21 differences, among the clearinghouses back then,
22 and I think a lot of changes have taken place where

1 there is probably more commonality toward those,
2 but I'm not sure if anyone has done a thorough
3 study of the various default procedures at the
4 clearinghouses in protecting the claims of the
5 individuals, and that might be something to think
6 about as we go forward.

7 Thank you.

8 COMMISSIONER LUKKEN: Andrea.

9 MS. CORCORAN: I just mention in passing
10 that as a result of Barings, one of the
11 international responses was to make default
12 procedures more transparent, and, in fact, there
13 has been a move internationally to make these
14 procedures more transparent. It's not perfect, but
15 you can look at that central counterparty
16 consultative document and you'll see that that is
17 the international standard, that the procedures
18 should be transparent, and I think around the
19 world, you see people putting more of their
20 procedures on their websites and putting more of
21 them into English where the language of the market
22 isn't necessarily English just because English has

1 become the lingua franca of the financial markets.
2 But I think that to put additional public pressure
3 for transparency on these procedures is important,
4 and I think we should perhaps review our own
5 markets to be sure that they have their procedures
6 up and posted.

7 COMMISSIONER LUKKEN: Kevin.

8 MR. DAVIS: Of course, for the purposes of
9 this community, if a company goes bankrupt,
10 provided they meet their obligations to the
11 exchanges and the clearinghouses, leaving aside our
12 emotional views of the matter, it's not really our
13 problem. One of the things that, again, I'm
14 concerned about is--and I'm not speaking on behalf
15 of Man--is that the fact that now you have
16 exchanges competing with exactly the same products,
17 and they're cutting fees and they're
18 cutting--giving all these breaks. The next place
19 for them to compete is in the area of risk, and
20 when you have energy or stock index or currency or
21 other contracts which are identical and trade on
22 different exchanges, and those--some of these

1 clearinghouses are now either public themselves or
2 part of a public company, there is a danger that
3 these organizations will think more about the
4 commercial imperative of getting the client in the
5 first place than of their role as providing an
6 exchange with perfect integrity. And I think that
7 is something we do need to be concerned about.

8 COMMISSIONER LUKKEN: John.

9 MR. DAVIDSON: I'll respond to that,
10 because I'm not sure that's really a very large
11 risk. I think exchanges and particularly those
12 that are subject to the discipline of being part of
13 public markets themselves are very keenly aware of
14 the fact that they are in business and they are
15 able to return funds to their shareholders because
16 of the integrity of the markets and that if they
17 compete unnecessarily on risk and don't have sound
18 financial integrity, they're simply going to go out
19 of business and people aren't going to use their
20 products. So I think the fact that there are
21 similar products traded on multiple exchanges is a
22 good thing, and I don't really think they're going

1 to act in a manner that's irresponsible their
2 because they understand the difference between
3 meeting next quarter's earnings target and being in
4 the business for their shareholders for the long
5 haul.

6 COMMISSIONER LUKKEN: Kevin.

7 MR. DAVIS: I don't share that view, but
8 it's a good point. I mean, there are--there have
9 been instances in the last few years, without
10 naming particular examples, where exchanges have in
11 our view been somewhat late or slow in raising
12 their margin requirements in line with different
13 market conditions, and we've felt--we often feel
14 when those circumstances happen, that it's
15 commercially driven.

16 So I take your point, but I disagree.

17 COMMISSIONER LUKKEN: Mr. Collins.

18 MR. COLLINS: I knew this will shock
19 Kevin, but I actually agree with him. The paradigm
20 is not completely indifferent from many of the
21 challenges banks faced throughout the '80s and '90s
22 where money was abundant and credit policies were

1 more abundant, and you did see environments where
2 people competed on what in effect were very loose
3 risk management policies.

4 I don't envision currently, certainly not
5 in the case of NYMEX and I'm not aware of other
6 markets, where that has become a competitive
7 sensitivity. That has not bubbled up yet to me in
8 the marketplace, but in a theoretical framework, I
9 think Mr. Davis is correct in that you can envision
10 an environment where there is intense competition
11 because prices have been squeezed as far as they
12 can be squeezed, as the case is in NYMEX, and
13 people choose to compete on the next level of
14 savings, which would be that of capital. So it's
15 something to be mindful of.

16 COMMISSIONER LUKKEN: Harry, do you have a
17 question or a comment?

18 MR. FALK: Yeah, I have a comment. I just
19 wanted to say--I hate to say it, but being in the
20 same building as Bo, I guess we think somewhat
21 alike. One of the things I would say is that over
22 my experience in this business, that the major

1 problems that have occurred have been because
2 people were competing. I'm not talking necessarily
3 about exchanges, but I'm talking about in trades
4 where they start doing silly and stupid things to
5 do business, and they wind up taking risks for far
6 less than they should be taking them for, and I
7 agree with Kevin that it can happen in exchanges
8 too. I mean, if an exchange becomes very concerned
9 about their bottom line and begins to do business
10 just to do business and they have to do the
11 business, then they may take risks that they should
12 never do.

13 MS. MEDERO: It doesn't take a public
14 company to take those risks, though.

15 COMMISSIONER LUKKEN: George.

16 MR. CRAPPLE: We are talking about the
17 CFTC approving cross-border linkages and
18 bankruptcy?

19 I would just make the observation that
20 obviously the Commission has to make a
21 determination that another country has a rational
22 and enforceable bankruptcy regime, and there are

1 certainly many countries that do not. Then I think
2 it is critical that the differences from the U.S.
3 Regime be toted up and taken note of, and as Bernie
4 said, the customers should know that there are
5 differences, but I don't think that the fact that
6 there are differences between rational bankruptcy
7 regimes should be used as a way to block
8 cross-border linkages, which I think is going to be
9 a great step forward for the financial community in
10 general.

11 COMMISSIONER LUKKEN: Well, it seems to me
12 that if I sort of summarize the discussion here, it
13 sounds to me that Art has suggested that there
14 might be some way to encourage informal discussions
15 between the participants of clearing, the
16 regulators, the market participants, so that if a
17 crisis happens, we're able to act quickly before it
18 happens, hopefully. But it sounds like there may
19 be some other issues, whether it's transparency of
20 rules that Bernie brings up or Andrea, that also in
21 the bankruptcy issue that might be worth the group
22 further exploring.

1 So what I would suggest, and we can talk
2 about this at the end, but I'll throw it out
3 for comment, is that we start a subcommittee on
4 this issue to see if there are matters that we can
5 put forward to the entire committee for consensus
6 vote. This would be at our next meeting, but we
7 assign a subcommittee chair. Art, hopefully he has
8 agreed to chair that if we agree to do this, but
9 unless there is any objection, I think--as they
10 say down south--there's meat on that bone. So we
11 might be able to find some substance here that we
12 can further on the bankruptcy issue.

13 Does that sound reasonable? Now my next
14 question is a logistical question. I've been told
15 that some people may want to take a five-minute
16 break to use bathrooms, get coffee and so forth.
17 We can do that, but I'm a democratic sort. If
18 people want to continue, we're sort of on the
19 downhill side of things. So if people want to
20 continue, we can do that, but I'll just sort of
21 pose a question here. Would people like to take a
22 quick break here for five minutes and then

1 reconvene to finish up our discussions?

2 Yes? Is that right? We'll meet back here
3 at 4:10. How does that sound?

4 [Recess.]

5 COMMISSIONER LUKKEN: All right. We're
6 back.

7 Well, the good news is that our discussion
8 on anti-money laundering, the two people, Emily
9 Ziegler and Pat McCarty, have agreed to do that
10 next time. So we've cut 15 minutes from our
11 program. So we may be back on schedule here.

12 I wanted to start off, and I think there
13 are a couple more issues I wanted to talk about
14 on clearing. To start out, I wanted--I had asked
15 Bernie Dan to do sort of an overview on customer
16 funds and how they're protected in the U.S. versus
17 overseas and to sort of lay out that discussion and
18 again turn to Art Hahn to talk tax issues, which
19 may or may not be something we want to deal with
20 out of this committee, but certainly a big issue in
21 regards to international transactions. Then to
22 finish the day, I'm going to turn it over to our

1 Division of Enforcement Chief, Greg Mocek, who will
2 present some of the international enforcement
3 matters that are before our agency right now.

4 So again, I'll turn it over the Bernie and
5 he can lay out his view on segregated funds versus
6 secured accounts.

7 MR. DAN: Okay. Thank you. Segregation
8 of client funds has been a longstanding, important
9 and effective policy protecting the sanctity of
10 U.S. client funds used for trading futures on U.S.
11 Markets for a long time. There have been a very
12 limited number of instances in the Commission's
13 history when it has determined that it was
14 sufficiently prudent and appropriate to permit
15 other funds to be commingled in segregated
16 accounts. The Commission has wisely determined
17 that the protections afforded by the requirements
18 for separate segregated and secured accounts are
19 important and, in my opinion, should not relax such
20 protections to point of evisceration of the
21 segregated funds policy.

22 Segregation insulates customer funds not

1 only from proprietary house accounts, but also from
2 cross-border regulatory and legal wild cards and/or
3 arbitrage, some of the same topics we mentioned
4 earlier. It grants certainty on those two fronts
5 to U.S. clients trading U.S. products and should
6 continue to do so. Regulation 30.7, which requires
7 secured amounts for transactions in foreign futures
8 and options to be kept separate from segregation
9 was designed, according to the CFTC at the time,
10 not to promulgate rules which in any way would
11 diminish the pool of funds available to domestic
12 customers trading on U.S. exchanges in the event of
13 a firm failure and not create bias in favor of
14 trading of foreign products.

15 Arrangements that would allow foreign
16 unregistered clearinghouses to have major control
17 over clearing processes for U.S. participants,
18 including those participating through a U.S. DCO
19 raise unprecedented issues of concern in this
20 regard. It is important to remember the conditions
21 that apply to some of the existing cross-border
22 linkages. In the case of CME and MEF, MEF became a

1 special clearing member of the CME, but what was
2 subject to meeting security deposit requirements
3 and CME assessment powers. Also under MEF's link,
4 all original and variation margin was collected by
5 the CME and maintained in U.S. accounts.

6 CME and SIMEX, SIMEX put in place a
7 comprehensive segregation rule that did not exist
8 prior, and in the case of COMEX and the Sidney
9 Futures Exchange, SFE trades were cleared on COMEX.
10 All funds to margin, guarantee or secure those
11 trades were held in segregation in U.S. by FCMs and
12 COMEX clearing. So I think the point about secured
13 and seg is that it served a purpose when it was
14 first formed. I think we have to be very careful
15 on creating exceptions to that policy, and if, in
16 fact, we're going to continue to create exceptions
17 to the policy, we should actually review why it
18 exists to begin with.

19 So with that, I'll just open it up to the
20 floor for any discussion.

21 COMMISSIONER LUKKEN: Anybody else have
22 comments? Opposing views?

1 Yes, Kim.

2 MS. TAYLOR: I would have to agree with
3 Bernie. Obviously, he's my largest customer, but
4 besides that, he happens to be right. We actually
5 do take a similar view toward the separation of the
6 segregated funds and the secured funds pools, and I
7 know that we're the example. The CME links, a
8 couple of the CME links are the examples for a
9 couple of the major cases where there has been
10 commingling, basically, of the segregated and
11 secured pools.

12 Bernie talked a little bit about the MEF
13 link. I wanted to just elaborate on that a little
14 bit. In the case of the MEF-CME link, effectively
15 what happened is that a foreign contract market
16 contracted for clearing services for some of its
17 products with the U.S. DCO. That's effectively
18 what happened. All of the clearing activity in the
19 products in question happened through the CME
20 Clearinghouse subject to all of the normal CME
21 clearinghouse risk management protections and
22 policies and practices. Because it was a

1 cooperative product venture, there was an
2 additional step taken where we effectively gave MEF
3 the ability to, by meeting almost all of our
4 clearing member requirements, clearing membership
5 requirements, to be become effectively a clearing
6 member on the CME's books to facilitate trading and
7 clearing in these products by their members, their
8 clearing members, without having to become
9 separately members of the CME.

10 So all of the funds were held in
11 segregation because all of the clearing happened at
12 a DCO. So I don't necessarily look at that as
13 really an exception.

14 The other link that is mentioned is the
15 Singapore CME link, and in that case, the--that
16 process was really an ability for both markets to
17 extend trading hours to be around the clock in the
18 time when there weren't computerized overnight
19 trading systems. So back in 1984, CME extended its
20 trading day for eurodollars by having the ability
21 for its clients to open or liquidate positions in
22 Singapore, and the Singapore market participants

1 could do the same thing around the clock by
2 using--virtually around the clock by using the CME.

3 In the case of that link, there is
4 novation at the local level domestically in both
5 cases. Trades are cleared at Singapore. Trades
6 are cleared at CME, and then certain of those
7 trades are cleared across the two exchanges with
8 another--like a cross-border novation, and the
9 trades that come over to CME become, again, fully
10 subject to all the risk management policies and
11 practices of a U.S. DCO, and the funds to support
12 those positions are subject to segregation. The
13 positions that go over to Singapore become
14 positions of the Singapore exchange and are subject
15 to their risk management protections, which include
16 segregation, but are not part of the U.S.
17 Segregation pool.

18 So both cases are cross-border linkages,
19 but they're not--in both cases, there was an
20 exception to the seg and secured pools, but they're
21 very different, I think, from some other potential
22 exceptions.

1 COMMISSIONER LUKKEN: Art.

2 MR. HAHN: I think Bernie put his finger
3 on the challenge for us, and that is maybe go back
4 and look at why do we have the secured amount. Do
5 we need to be in a separate pool? I don't know the
6 answer. It might be yes. It might be no. But
7 what are the underpinnings of it and do they apply
8 to the world that we now live in as opposed to what
9 we lived in at that time. I think that's a worthy
10 effort.

11 Were you to go forward and allow the
12 commingling of them, there is a very significant
13 effect that we all ought to, you know, just be
14 aware of. It will make it dramatically easier for
15 FCMs to function. It will save money. It will
16 allow for fungibility of money, and it will
17 certainly expand the scope of margin offsets
18 between foreign and domestic product, which is now
19 inhibited because of the separate pool. You can't
20 net across the two different pools. If they're in
21 a single pool, you expand the scope for that.

22 The starting point ought to be, as Bernie

1 suggested, is it safe, it is prudent, it is the
2 right to do in this age. If you got to the place
3 that you concluded it was, there are some
4 significant benefits to the marketplace that may
5 flow from that.

6 COMMISSIONER LUKKEN: Dennis and then
7 John.

8 MR. DUTTERER: First, unlike Kim, I cannot
9 say Bernie is my largest customer.

10 MR. DAN: But I used to be Dennis, used to
11 be.

12 MR. DUTTERER: Bernie used to be. Bernie
13 also used to be on our board. So we go way back in
14 that.

15 But even though Bernie is no longer the
16 largest customer, I will say he's--I do share his
17 views that anything, any action taken by the
18 Commission on the cross-border activities,
19 cross-border clearing and including particularly
20 the seg and non-seg issue, you can have to protect
21 from cross-border wild cards. There is no doubt
22 about that. And I think the example cited, MEFF,

1 SGX, the CBOT-Liffe, LCH-Clearnet corp link on the
2 booms in which the CFTC permitted those funds to be
3 placed in one account for positions and the
4 positions were then later transferred over to LCH,
5 are examples which I don't think should be viewed
6 as exceptions, but viewed as implementation of
7 policies that consider the factors which Art
8 mentioned and which are many of those which should
9 be appropriately considered to facilitate really
10 the cross-border links to facilitate commercial
11 activity.

12 MR. DAVIDSON: I have to say that I think
13 the whole distinction between secured accounts and
14 segregated accounts in this day and age is a very
15 artificial one and, in fact, inhibits the
16 competitive position of the United States vis-a-vis
17 other markets around the world. I think there are
18 a number of limitations with this view, although in
19 the extreme, it may be an inadequate customer
20 protection.

21 First of all, it's a binary view of the
22 world, and I think we just got done hearing from

1 Art Hahn that at least when it comes to bankruptcy
2 regulations, the world is not a binary place. So
3 it's not the case that every jurisdiction outside
4 of the United States that the CFTC has so far
5 allowed U.S. customers to participate in the
6 futures markets has exactly the same level or lack
7 of level of protection of customer assets in the
8 event of an insolvency, but you would be led to
9 believe that from the binary distinction between
10 whether something is a segregated fund or a secured
11 amount fund.

12 Second, I find it fairly curious that when
13 we look around the global regulatory marketplace,
14 and certainly there are European regulators who
15 have some fairly unsophisticated customers and
16 there are Asian regulators who have some fairly
17 unsophisticated customers in their jurisdiction, we
18 are virtually the only jurisdiction that has made
19 this distinction, and I think it derives more out
20 of the insular nature of the American economy than
21 it does out of a current recognition of the role of
22 cross-border financial transactions in the modern

1 marketplace.

2 So I think that absent, obviously, a
3 particular application and a particular point in
4 time, it's not the right place to make precedent
5 changing regulatory changes, but I think the next
6 time there is a comprehensive review of CFTC
7 regulations in this regard, it would be appropriate
8 to take a look at does this distinction still have
9 merit in the modern financial world and do
10 customers who, after all, can buy Ford Motor
11 Company, which derived, I believe, 63 percent of
12 its earnings from outside the United States and has
13 certainly got a whole host of affiliates that are
14 subject to foreign insolvency rules and certainly
15 is subject to a lot of foreign exchange risk and is
16 certainly established subject to a lot of risk with
17 respect to the rule of contract law in different
18 jurisdictions. If a retail investor can buy Ford
19 Motor Company, I don't understand why a retail
20 investor doesn't have the sophistication to
21 understand the distinction that things are somewhat
22 different if he trades a contract on an exchange

1 outside of the United States.

2 MR. BERLIAND: I would just like to
3 elaborate a little bit on what John was
4 saying, perhaps give a little bit of feedback of
5 for what current perception is on segregation and
6 protection outside the U.S., and the first thing I
7 would say is I completely agree with John. It is
8 frightening the low level of knowledge that exists
9 among so many clients outside the U.S. about
10 segregation and protection in general. There are
11 still clients out there who believe that the
12 concept of segregation, whether under U.K. or U.S.
13 Law actually means "designation," meaning that
14 their client is wholly segregated from any other
15 client, let alone segregated from the house broker
16 or house entity.

17 That education process, despite the fact
18 that we are as many years post-Barings and
19 post-Griffin as we are today, as staggering as it
20 may be, it still persists, and every year as new
21 countries come online and start gaining access to
22 the international markets, that education process

1 actually becomes harder, not easier. As we said
2 earlier, another ten accession countries in Europe,
3 all of whom are starting to grow their use of
4 futures, and this is an alien concept. So this
5 education process remains, I think, a very big
6 factor.

7 The second thing I would say is that most
8 clients, given the choice of whether to opt for
9 segregation or not, will take segregation. One of
10 the curiosities of the U.K. rule is that with many
11 counterparties in the U.K., you can choose whether
12 to go for client money protection or not. It's an
13 unusual arrangement, but you're actually giving the
14 client a choice as to which environment in which to
15 operate. Most clients, curiously, will prefer the
16 U.K. concept of segregation where all affiliate
17 vehicles of the broker are segregated away from the
18 client pool rather than the U.S. model where it is
19 just the legal entity that is the broker that is
20 segregated away.

21 So even within segregation itself, the
22 difference between the two interpretations, there

1 is still a preference, I would say, for the broader
2 definition of segregation where all of those
3 affiliates are taken in there.

4 I would also highlight that in a country
5 such as Germany where no segregation exists today,
6 the German clients are amongst the most demanding
7 in wanting segregation. So it is not a commercial
8 reason that EUREX turns around and says EUREX
9 clearing will not offer segregation. It's just the
10 legal structure in Germany does not enable them to
11 do so. So it's not, as I say, not pure commercial.
12 It's not a lack of willingness, and the client
13 certainly, when given that option will always opt for
14 segregation.

15 So I guess to summarize my points here, I
16 think, A, it is a big educational program and none
17 of us, I think, should take for granted the fact
18 that we've been debating this topic for more than
19 ten years now, should assume that the client base
20 at large--in my case institutional, but I'm sure in
21 retail even more so--are really truly cognizant of
22 the way this program works. They don't.

1 And the second thing is that I would agree
2 with John. I think it does warrant reviewing this
3 separation of U.S. domestic away from the Part 30
4 activity. Again, I don't think its particularly
5 urgent, but when it is housekeeping, it will be
6 worth taking a look at.

7 MS. TAYLOR: I can see the points that
8 both John and Richard are making, and I wouldn't
9 want to suggest that a review of whether
10 segregation and secured separation is necessary.
11 What I would suggest, though, is that I would
12 consider it to be not--certainly not a housekeeping
13 matter and not so much a matter that can even be
14 looked at in isolation away from the bankruptcy
15 implications of segregation. It's not so much just
16 waving the wand and getting rid of the mechanics or
17 the operational implications of having to have the
18 two pools. The very protection that the U.S.
19 Customers depend upon, I think, in a bankruptcy
20 comes from not having their pool at risk to risks
21 that the CFTC has no jurisdiction over, risks of
22 foreign contract markets, risks of foreign

1 clearinghouses, risks of foreign bankruptcy
2 jurisdictions.

3 So I think it needs to be looked at a
4 little more holistically than it sounded like
5 Richard and John were maybe suggesting.

6 COMMISSIONER LUKKEN: Is there any more
7 discussion on this?

8 Well, it seems to me there's not really a
9 consensus on how this should be treated. The only
10 consensus I could maybe find is that we need more
11 information on this. I think the public policy, as
12 John pointed out, is protecting customer funds.
13 I'm sure there are different mechanisms around the
14 world that do that as well. Segregation is
15 probably at the top of that list, but certainly,
16 you know, if we're asking for free trade, and by
17 definition it's a bilateral street or maybe
18 multilateral is the preferred word, that these
19 are some things that we have to think about,
20 especially if our markets want to enter other
21 jurisdictions as well.

22 So maybe this is something informally we

1 can discuss after the meeting and see if there is
2 movement or at least some information sharing we
3 can have on this.

4 Yes. I'm sorry, George.

5 MR. CRAPPLE: Just a quick observation, I
6 don't think the discussion should take as a premise
7 that seg funds is some panacea that protects
8 customers against losses, because it's very obvious
9 that a big customer can incur a huge loss and there
10 won't be enough seg funds. So it's not a guarantee
11 against loss, and there are lots of risks with seg
12 funds.

13 MR. DAN: Well, the only thing I was going
14 to add to your comments is to consider all those
15 protection of funds in the context of the
16 bankruptcy issues as well. They are related.

17 COMMISSIONER LUKKEN: Andrea.

18 MS. CORCORAN: I would say that the
19 importance of segregation in the past has been that
20 the funds were defined as belonging to the
21 customer. So as a matter of law, they couldn't be
22 taken by creditors of the broker carrying the

1 funds, and internationally, that's been the big
2 move, is to try to be sure that you've identified
3 funds that are held as margin in a way so that they
4 can be transferred away from a defaulting
5 intermediary when the customers themselves are
6 still capable to meet their obligations to the
7 market, the reason being that that would make any
8 kind of event a less significant event than if all
9 of the customers refused to make further payments
10 to the market.

11 To remind people, this was not an
12 insignificant issue in the Barings case, because
13 the reason people made their 60 percent margin
14 payment, the brokers, is because Cobin Sang,
15 who was then the head of the MAS, at
16 the request of the chairman of the CFTC, I might
17 add, told the market that any payments that were
18 made into that market subsequent to the knowledge
19 about Barings would not be taken to rectify a
20 default, but they would be used to fund each
21 participant's ongoing future obligations in the
22 marketplace. I think that segregation also--I

1 mean, I think it's a good thing to look at again,
2 but you should also remember that whenever there is
3 a default, we never get calls at the CFTC saying,
4 Please, I was just calling to find out that I was
5 not segregated. I mean, I know that in the U.K.,
6 that the locals who had opted out of segregation
7 said, indeed, they must have intended to be
8 segregated in the Griffin case, and that's usually
9 the way these things go down.

10 And I guess the final point would be is
11 that there is an unfortunate feature in the U.S.
12 Bankruptcy law, and that is that it seems to
13 contemplate that there will be sort of a collateral
14 against which customer claims can be, you know,
15 made, and so every time there is a case in the
16 courts, there is a big debate about whether you can
17 go and get any more money than the money that's
18 actually in the segregated pool, and, I mean, one
19 of the worth features of the *Griffin* case is they
20 seem to contest that idea when the whole idea of
21 the bankruptcy law in 1978 was to permit you to go
22 beyond the seg pool. So if you could actually get

1 a bankruptcy law that said that there was a
2 customer priority and that any funds that were
3 deposited in respect of customer positions were not
4 funds of the broker and could be moved, then you
5 wouldn't have to make these distinctions.

6 A final feature of the distinction is
7 Kim's point, Kim Taylor, that by having the secured
8 amount, what was that supposed to mean is that if
9 the U.K. had a completely separate way of
10 addressing bankruptcy, that you could go ahead and
11 apply their bankruptcy law to the secured amount
12 fund without in any way undermining the ability of
13 a U.S. futures exchange, because bankruptcy
14 protects the market from settling its market and
15 having whatever the attendant, you know, risks of
16 that would be. So I think it's not a minor thing
17 to think about, how this should be worked out,
18 which isn't to say that there aren't other ways to
19 do it that would achieve the same protections.

20 COMMISSIONER LUKKEN: Get her on your
21 subcommittee, by the way.

22 John.

1 MR. DAVIDSON: Just to clarify my ingoing
2 position, I was not suggesting that one ought to
3 abolish the notion of segregating client assets
4 from firm assets. What I was suggesting is the
5 distinction between secured amounts and segregated
6 funds is a distinction that you could lose. Last
7 time I checked, I'm not allowed to commingle
8 proprietary positions and secured funds anymore
9 that I'm allowed to commingle proprietary positions
10 and monies and segregated funds, and I have an
11 obligation to top up both, and allegedly someone
12 understands which of those two obligations I meet
13 first, but I would bet in the event of the
14 insolvency of Morgan Stanley, there will be a path
15 beaten to the courthouse to decide whether I should
16 have topped up seg funds first with my remaining
17 capital or secured funds first.

18 COMMISSIONER LUKKEN: With that, I will
19 turn to Art Hahn to finish up our discussion on
20 clearing and taxation issues, and he promises to be
21 brief.

22 MR. HAHN: I was going to say my death or

1 bankruptcy was elongated and lingering. Taxes are
2 going to be quick.

3 Just a couple of comments on the U.S. tax
4 regime. It's called 60-40. There is a split
5 between long-term and short-term capital gains,
6 which, rough numbers, results for individual
7 taxpayers in a 12 percent benefit in trading on
8 markets that the IRS blesses. So the question for
9 us, it seems to me, is how does one obtain the IRS
10 blessing to get that benefit and are there issues
11 around that that would concern us. By the way, I
12 think our bottom line--my bottom line is I think
13 it's probably outside of the purview of this group.
14 I think it's ultimately a tax question, but let's
15 go through it.

16 The 60-40 treatment is embodied in 1256.
17 It says that if a transaction takes place on a
18 CFTC-blessed exchange or another conceivably
19 foreign exchange that the IRS designates, and
20 they've designated Bermuda and Montreal, I believe,
21 historically, you can get the 60-40 tax treatment.

22 In the early days, nobody thought anything

1 about clearing. It was always talked about in
2 terms of an exchange. You began to think about
3 clearing when the CME-SIMEX transaction took place.
4 There, the trade potentially takes place on SIMEX,
5 which is not a designated exchange, but pursuant to
6 an application of the CME, they've said, look, when
7 you start the trade, you've designated that it's
8 going to come back and live at the CME, and by live
9 there, it will reside at CME clearing, and it's a
10 closed system. It's a certainty, and once it comes
11 back to CME clearing, we're going to deem it to be
12 under the rules of the CME, which is a recognized
13 exchange, short cut, therefore we'll give it 60-40
14 treatment.

15 That's the first time that clearing seemed
16 to come into the mix, and you wonder, well, does it
17 make any difference. I would suggest to you that
18 by just looking at the statute, it doesn't make any
19 difference. If you wanted to speculate and probe
20 it a little bit, you could look at what the IRS
21 really cares about. It seems to me that what the
22 IRS cares about is that it's got a mechanism for

1 getting information about U.S. taxpayers. Members
2 of U.S. exchanges have to provide that information
3 to the feds and tell them how much you made or lost
4 in the market.

5 The second thing that the IRS cares about
6 is that the organization has the mark to market
7 facility, because the secret to the 60-40 tax
8 treatment is that you don't have to have realized
9 the gain. Under this particular provision of the
10 tax law, you are taxed not on realized gain or
11 loss, but on the mark to market at the end of the
12 tax year, generally December 31, and exchanges can
13 calculate what your position is as of that date.
14 You can then figure out the tax, and the IRS can
15 get your name and that number from an exchange
16 member who is obligated to provide the information.

17 I guess it's--that was the way the whole
18 thing was constructed. It has nothing to do with
19 clearing. One could ask the question: could a
20 stand-alone clearing organization provide the IRS
21 with that information, and maybe the answer is yes,
22 you know, theoretically an exchange could calculate

1 the mark to market and--rather, a clearing
2 organization--and a clearing organization might
3 adopt a set of rules that says its clearing members
4 must provide the IRS with information. That's not
5 where we are today. There is no indication that
6 the IRS wants to go in that direction certainly
7 without some indication from Congress, and although
8 it is clearly part of the competitive battlefield
9 between foreign and domestic exchanges, I don't
10 know that it is something that either this
11 committee or the CFTC ought to get in the middle
12 of.

13 But that's one man's view, and I'll stop.

14 MR. CRAPPLE: Well, thinking back to when
15 this regime was put in place, I think one of the
16 principal reasons that the IRS retained the
17 authority to examine what exchanges would be put
18 under the mark to market regime was there were a
19 lot of phony trades going on, for example, in
20 London options markets. The whole regime was put
21 in because of abuses of tax straddles. So I think
22 the IRS wanted to see is this a legitimate market

1 with rules and honest trades. I don't think it's
2 so much reporting back to the U.S. I think a
3 reason in supporting that point of view is that the
4 mark to market regime was extended over the counter
5 for an exchange trading on any currency that
6 happened to be traded on a U.S.-designated
7 exchange. So, I mean, nobody is reporting to the
8 IRS necessarily the trades that you're making on
9 over-the-counter foreign exchange markets.

10 So I don't think it's a reporting thing so
11 much. American taxpayers are expected to report
12 their income on a voluntary basis whether or not
13 it's being reported by some third party. So--and
14 as far as the mark to market facility goes, I mean,
15 virtually any market with published closing prices
16 can meet that requirement. I guess I've been
17 puzzled over the years why more of the non-U.S.
18 Exchanges haven't sought designation as 60-40
19 markets, and the only explanation I've ever heard
20 was they somehow think they're going to be in the
21 clutches of the U.S. Government if they do that.

22 MR. HAHN: I can speak to it. George,

1 your point in terms of legitimate markets and good
2 trade practice on those markets so you don't have
3 pre-arranged trades and wash trades and so on is
4 exactly right. That was part of the origin of it,
5 but, indeed, the reporting obligation has been the
6 sticking point. I actually sat with the IRS and
7 explored on behalf of foreign exchanges getting a
8 designation, and the requirement was that you, the
9 foreign exchange, will adopt a rule which requires
10 all of your members to provide information directly
11 to the IRS concerning U.S. transactions, and the
12 foreign exchange memberships weren't excited about
13 that.

14 The other element is that with the 60-40
15 treatment comes the mark to market obligation, and,
16 indeed, there are taxpayers who aren't excited
17 about that requirement who would rather have it on
18 a realized basis rather than a mark to market
19 basis. So that's been the way the battle has been
20 fought, but I'm aware that the IRS, in order to
21 give a foreign market the designation, their key
22 point when you sit down at the table with them,

1 they say, yeah, I assume you've got some pretty
2 good rules and stuff; tell me about requiring
3 reporting of the taxes. That's been their
4 position.

5 COMMISSIONER LUKKEN: I'll just conclude
6 the tax discussion by saying I think any input we
7 might be able to give in this area probably has to
8 be from the very general policy arena. Having come
9 from the Senate, there are lots of good ideas that
10 are based on sound policy, whether they're health
11 care tax credits or child care tax credits or
12 whatever. So I think anything that we might
13 provide either Treasury or IRS on this would be
14 from sort of a public policy point of view that we
15 want to encourage a certain type of behavior, and
16 this might be a mechanism to do that.

17 It doesn't sound like this is fleshed
18 out enough, but certainly, as you think about
19 this over the next few weeks, if it seems that
20 there is something here that we should be
21 supporting in a letter or something that might
22 be generated on this front, please let us know

1 and we'll see what we can do on this and get
2 some consensus.

3 IV. INTERNATIONAL REGULATORY
4 COORDINATION/ENFORCEMENT HARMONIZATION

5 COMMISSIONER LUKKEN: With that, I will
6 turn it over to Greg Mocek who is going to wrap up our
7 session and talk about some of the international
8 enforcement issues that have been on our radar
9 screen.

10 MOCEK: Thank you all for putting me at the
11 end of the program when everybody is getting ready
12 to get on planes. Art mentioned something earlier on
13 that I agree with when he said that 90 percent of the
14 problem is cured when the funds have been secured,
15 whether domestically other or overseas. For us in
16 enforcement, that's true but we also have the added
17 burden of where are the records, where are the
18 audio tapes, and where are the witnesses.

19 In many ways as the commodity markets
20 become more and more interrelated across all
21 sectors, it's easier to make money cross border
22 than it is to prove a case and we are working from

1 every angle in an attempt to speed up not only the
2 investigations that are underway but also the
3 procedures and policies in place on our shores and
4 the shores abroad that we work with on a daily
5 basis, whether it's coffee, sugar, or natural gas
6 and coal, crude, what we're seeing now as the
7 markets evolve, we're seeing markets that have an
8 impact on each other in a different way than
9 they've had an impact on each other in the past and
10 the enforcement program has to focus and refocus
11 and devote resources in those particular areas
12 which may have an impact on your programs, your
13 companies and your exchanges and for your clients.
14 Interrelated examples that we've seen just
15 recently, none involving illegal activity, but just
16 in the past year, you saw prices increase in steel
17 internationally. That had an impact on coal prices
18 in this country.

19 Another example is as I go to various
20 conferences we talk about how LNG, liquefied natural
21 natural gas, is going to be the big thing in
22 future and transcontinental shipments of gas,

1 will change the way that people trade energy on the
2 cash markets. What is that going to do to the
3 international markets and more particularly, to the
4 markets that trade in the United States and how we
5 monitor those markets for manipulative conduct?
6 That's something that's important and something
7 we've had to think about as these issues evolve.

8 Imagine, over the past two years we did
9 50 manipulation investigations of major public
10 companies who had the best counsel in the country
11 and used the resources of a small staff of 150
12 government servants to do that in the division
13 and with the help of the other divisions like
14 DMO and the Chief Economist's Office. But what
15 if those 50 investigations were somehow investigations
16 that involved international conduct? We have to
17 be able to cope with that as we move in the
18 direction which could possibly happen in the
19 next five or ten years.

20 From energy we go to traders that are
21 trading now from laptops in Gibraltar, which you
22 hear about everybody to trading arcades in London,

1 where traders are sitting next to each other,
2 possibly colluding, to situations where you've got
3 boiler rooms in Miami that you could read about on our
4 website every day, stealing money from people using
5 international credit cards with no name on the
6 card, just an account number and then moving U.S.
7 customer funds to jurisdictions that are sometimes
8 impossible to deal with from an enforcement
9 perspective. All issues that are on our radar and
10 all issues that we have to cope with, issues that
11 may come across your screen, as people think of
12 creative ways whether it be in tax strategies or
13 simply through mechanisms in the market where they
14 wash trade or manipulate, are all things that we need
15 to be cognizant of.

16 Never before have the domestic regulators
17 worked so well with each other. And a big
18 part of that is the President's Corporate Fraud
19 Task Force. The President's Corporate Fraud Task
20 Force has done a tremendous job in facilitating our
21 communication, whether it be with the Fed, or the
22 IRS or with the SEC, whoever, the U.S. Attorneys

1 around the country. It's working wonders and we're
2 seeing results.

3 The same is true internationally. Never
4 before have international regulators shared so much
5 information and reached beyond where they
6 previously protected information, documents and
7 witness testimony on their shores, allowing foreign
8 regulators to assess that information and or go
9 onto their shores to get the information. The
10 Commission, since as early as 1992, has been given
11 the authority to do investigations cooperatively
12 with foreign jurisdictions, do investigations for
13 those foreign jurisdictions on our shores and we
14 have used those powers extensively.

15 We made tremendous strides in cross-border
16 investigations and contact with regulators,
17 compelling testimony as well as gathering critical
18 information. But it's changed a good bit, and how
19 it's changed is in the more traditional ways of
20 information gathering where we had used letters
21 rogatory and the Hague convention and various other
22 means. When it took us year or a year and a half to

1 go through those processes to get documents and or
2 testimony, now we've moved to the MOUs and the
3 bilateral information sharing agreements that
4 people previously talked about. It could take a
5 year or year and a half under certain
6 situations. Under the MOU that we may have with a
7 country, it may take four weeks. Highly critical is
8 if you are dealing with monies that were stolen and
9 you want to freeze those monies up.

10 With the MOUs, from an enforcement
11 perspective, I have to say that 25 signatories to the
12 IOSCO MOU that are currently on that MOU are names
13 of countries that shouldn't be overlooked. As we
14 have an additional 22 bilateral MOUs, we use those
15 on a regular basis to gain information and
16 cross-border sharing information. But more
17 importantly, what it means to, I think, industry is
18 the fact that the multinational operations that you
19 have, if you're dealing in a country that is a
20 participant to one of those MOUs, it greatly
21 enhances our comfort level as a Commission when our
22 Division of Enforcement is asked how should we look

1 at this platform, how should we look at this
2 particular situation abroad in this particular
3 country, and if that country is not a signatory to
4 an MOU or doesn't have an informal sharing
5 agreement with us, and the flip side would be a
6 country that basically lifts its nose when we come
7 knocking, it becomes that much harder for you to do
8 business in that particular jurisdiction from our
9 perspective. We also want to facilitate the global
10 markets. So the more you can do to get people on
11 board through your discussions abroad and your
12 powers when you operate within the particular
13 jurisdictions, get people on board to sign up to
14 cooperative agreements with me us, I think the more
15 it improves the marketplace and improves your
16 ability to make money abroad.

17 We are, as I mentioned before, locating
18 assets more frequently abroad as well as freezing up
19 assets abroad. More and more jurisdictions around
20 the world are recognizing orders from U.S. district
21 courts to freeze up assets and I think a part of
22 that is a result of what's happened because of

1 things like the FATF blacklist. The FATF blacklist
2 was put in place to deal with those jurisdictions
3 that were not adhering to international standards
4 for money laundering, but it has had a domino
5 effect across many jurisdictions and has actually
6 opened a number of doors for international
7 regulators who did not work with us who are now
8 coming to the table.

9 I think the same is true when you talk
10 about the bankruptcy issues that you mentioned
11 earlier. Sometimes it takes a crisis like that and
12 hopefully there won't be an international crisis in
13 terms of liquidity that forces all those around the
14 world to work together and to come to some kind of
15 common standards where they facilitate the sharing
16 of information that helps everyone at the end of
17 the day.

18 The markets are evolving so much that we
19 are attempting to evolve with them, although we are
20 going to need industry help in certain situations.
21 Whereas, before we could have ex-police officers or
22 ex-traders, ex-brokers doing our investigations,

1 now we need forensic accountants and individuals
2 who are incredibly savvy at electronic trading and
3 computers. As we move forward, we're trying to
4 parlay the technology as well as the information
5 resources from our sister agencies, but we're also
6 going to need your help because no one knows those
7 markets better than you, your clients and your
8 companies. We welcome any feedback that you may
9 have in what we're doing in enforcement as we move
10 forward.

11 Thank you.

12 COMMISSIONER LUKKEN: Anybody have any
13 questions for Greg? Go ahead, Art.

14 MR. HAHN: I'll do it quickly, but I
15 certainly applaud the idea of working through MOUs
16 with cooperative countries. I think that's really
17 the key way to go. I think you need to think
18 twice about the impulse sometimes to say that the
19 cost of coming into the United States as a European
20 or an Asian company is to consent to personal
21 jurisdiction here. I think you would see is that
22 European communities don't ask that of U.S. firms

1 that come in. There is U.S. exchanges and
2 clearinghouses that do business all over Europe.
3 You're not seeing them asking for the personal
4 jurisdiction, and I would encourage you to maximize
5 the MOU route and the cooperation between
6 regulators.

7 Those regulators have their hands on those
8 people, on the audio tapes, on the witnesses. Go
9 down that pipe because I think to the extent that
10 you're reaching for more direct U.S. jurisdiction,
11 I think it's taken badly and it's inhibiting
12 the international commerce.

13 MR. MOCEK: Duly advised.

14 V. DISCUSSION OF FUTURE MEETINGS AND TOPICS

15 COMMISSIONER LUKKEN: Well, it's been a
16 good day. I appreciate everybody coming. There is
17 a couple of things we need to discuss before you
18 get to your planes, trains and automobiles.

19 The main thing is trying to figure out how
20 often as a group we should meet. You know, it's
21 been in the past where it's met as much as twice a
22 year. I know a lot of people are coming in from

1 London and elsewhere and that might be difficult,
2 but we certainly can do twice-a-year meetings if
3 people thought that was advisable. If there are
4 any thoughts on that, otherwise, we can
5 wait until next year to see folks and
6 certainly the subcommittees and other discussions
7 will be happening in between the larger meetings.
8 Does anybody have any views on that?

9 MR. BERLIAND: My advice would be that it
10 really depends on the material at hand. If we've
11 got some very meaty issues which quite clearly in
12 the clearing environment we really do, and it's
13 time-urgent, then that should be the real driver on
14 how regular it should take place.

15 I think that you should, at the beginning
16 of each year try and assess what the agenda looks
17 like for the industry during the course of that
18 year and then drive how many meetings are
19 appropriate. I would recommend not to be
20 prescriptive on how many, whether it's one or two a
21 year. I think it would be a shame to get back to
22 where we were before, where it lapsed. There is

1 definitely value in the forum.

2 COMMISSIONER LUKKEN: I think that's fair.
3 Anybody else? Why don't we do that. We'll weigh
4 the material that we have here and make a
5 determination on when we should meet. It sounds
6 like there is some meat there, so it may be sooner
7 rather than later on that issue.

8 Also, just to talk about some potential
9 topics for next time, and some people, in
10 RSVPing, have mentioned certain topics. Richard,
11 you had mentioned block trading. Do you want to
12 just give one sentence why this might be something
13 useful for us to take up?

14 MR. BERLIAND: Actually, the phrase was
15 not just block trading, it was off-the-exchange
16 trading. I just think it's a topic which causes a
17 high level of angst, certainly from a regulatory
18 point of view and I think it warrants a review.

19 COMMISSIONER LUKKEN: Another issue I
20 wanted to take up was the issue of China and that's
21 a broad issue, but that's where Roy and I first
22 met, over in Shanghai, and had a wonderful time

1 over there, but I know it seems to be a growing
2 market as far as commodity use in energy and
3 agriculture, and both exchanges—Chicago
4 exchanges--now have partnerships there. So I think
5 that might be something that we should explore for
6 the next meeting as well.

7 Bernie you had mentioned trade error best
8 practices.

9 MR. DAN: Yes, I think a couple of years
10 ago, I don't know the time frame, but the FIA led a
11 very effective global error trade policy of the
12 impact of electronic trading and a lot has changed
13 since that was originally developed having to do
14 with, you know, there's better risk controls and
15 there's more countries involved, etcetera, and I
16 just think that the more that those types of things
17 are standard in this industry, the better the risk
18 management is. And given some of the changes over
19 the last two or three years, I think it just
20 warrants a look at some level, whether it's at the
21 FIA or whether it's part of here I don't really
22 know, but it's something that with the growth in

1 the U.S. of just electronic trading, the dynamics
2 are just much greater than they were three-four
3 years ago.

4 COMMISSIONER LUKKEN: Are there any other
5 topics I'm missing that people may want to explore
6 for the next meeting? I see Barbara mouthing
7 something to somebody. Is there something?
8 You're not limited by today's discussion.
9 Go ahead, Roy.

10 MR. LEIGHTON: We talked a lot about the
11 bankruptcy subject today, but I think as that work
12 is carried out, there are other areas where we are
13 pretty ignorant of the level of investor protection
14 on a cross-border basis and I think once we've
15 dealt with bankruptcy, it would be useful to look
16 at things like authorization, conduct of business,
17 and get a much better appreciation of the standards
18 between the main nations that are at interest. As
19 you mentioned, China, I think it would also be
20 terribly useful if we could attract to this group
21 one or two people who truly understood the Asian
22 scene, because we've got enough people who

1 understand the United States and the European Union
2 but we are kind of missing people who understand
3 the Asian region.

4 COMMISSIONER LUKKEN: Good point. Well, I
5 think as far as the assignments for next time, we
6 will go over the topics that we've discussed. Art
7 Hahn is going to lead a discussion on bankruptcy
8 issues and the different things that we said flowed
9 from that. I think we need to explore segregation,
10 as part of that, was the idea to see if there is
11 some consensus we can find on the segregation
12 front. That may lead to your customer protection
13 issue, so I've tied it all together.

14 So, with that, thank you so much for
15 coming. I know many of you traveled great
16 distances, but we appreciate it and you certainly
17 help this agency. Before I leave, I just want
18 to thank everybody at the CFTC who has helped put
19 this together, the division heads, Pat McCarty for
20 not speaking, Erin Shaw, Dave Stawick and
21 Elizabeth Ritter on my staff and all other

1 people, administrative people that helped in
2 putting this together. Lastly, you're invited,
3 for those not catching an immediate train or plane,
4 up to the chairman's suite on the 9th floor to have
5 a cocktail. So hopefully you can join us.

6 (Whereupon, at 5:10 p.m., the meeting was
7 adjourned.)

8

9

10

11

12

13

14

15

16

17

18

19

20

21