

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
SECURITIES AND EXCHANGE COMMISSION

JOINT CFTC-SEC STAFF ROUNDTABLE DISCUSSION ON
PROPOSED DEALER AND MAJOR PARTICIPANT DEFINITIONS
UNDER DODD-FRANK ACT

Washington, D.C.

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5 MARK FAJFAR

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9 SEC:

10 ROBERT COOK

11 JOSHUA KANS

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P R O C E E D I N G S

(9:04 a.m.)

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3 MR. COOK: I think we're going to get
4 started. Good morning. If people could take
5 their seats.

6 Good morning. I'm Robert Cook. I'm
7 director of the Division of Trading and Markets at
8 the SEC and I'm going to offer a few introductory
9 remarks and then a CFTC staff will offer a few
10 introductory remarks and then we'll begin with the
11 panel discussion.

12 I'm joined on this panel by Joshua Kans,
13 who serves as senior special counsel in our Office
14 of Chief Counsel, and by Richard Grant, an
15 attorney in our office of Derivatives Policy.
16 It's our pleasure to welcome you to this Joint
17 CFTC/SEC Staff roundtable on the proposed dealer
18 and major participant definitions of Title VII.

19 On behalf of the SEC staff I'd like to
20 thank all of our distinguished panelists who are
21 here with us to share their insights, views,
22 recommendations, and thoughts on this very

1 important topic. We are grateful to each of you
2 for taking time out of your busy schedules and in
3 some cases for changing your schedules, to be here
4 today and we look forward to hearing your views.

5 I also want to extend a special thanks
6 to the CFTC for hosting this roundtable and to the
7 staff at both the CFTC and the SEC who have worked
8 tirelessly behind the scenes to make this
9 roundtable a reality.

10 Before continuing, for the record, I
11 need to give our standard disclaimer that all of
12 my remarks and questions and those of my SEC
13 colleagues participating in the roundtable
14 throughout the course of today, reflect only our
15 personal views and do not necessarily reflect the
16 views of the SEC, any individual SEC commissioner,
17 or other members of the SEC staff.

18 Also, before we dive into the
19 roundtable, I'd like to touch briefly on a few
20 more general issues that may bear on our
21 discussions today. First, I'd like to address our
22 efforts to address the Title VII effective date

1 issues. At the SEC we announced on Friday that we
2 intend to take a series of actions in the coming
3 weeks to clarify the requirements that would apply
4 to security-based swaps as of July 16th, the
5 one-year effective date of Title VII, and to
6 provide appropriate temporary relief.

7 The Commission took the first of these
8 steps yesterday issuing an order to provide
9 guidance regarding which provisions of Title VII
10 governing security-based swaps become operable as
11 of the effective date and providing temporary
12 relief from several of these provisions.
13 Specifically, the Commission's action makes clear
14 that substantially all of Title VII's requirements
15 applicable to securities-based swaps will not go
16 into effect on July 16th and it grants temporary
17 relief from compliance with most of the new
18 Exchange Act requirements that would otherwise
19 apply on July 16th.

20 As described in last Friday's
21 announcement, the Commission will soon undertake
22 two additional steps, first providing guidance

1 regarding, and where appropriate, temporary relief
2 from the various pre-Dodd-Frank provisions that
3 would otherwise apply to the securities-based
4 swaps on July 16th. And second, the Commission
5 will take other actions to address the effective
6 date including extending certain existing
7 temporary rules and relief to continue to
8 facilitate the clearing of certain credit default
9 swaps by clearing agencies functioning as central
10 counter parties.

11 I'd like to stress that our goal in
12 taking these actions is to provide clear guidance
13 on what will be required on July 16th and to
14 provide appropriate temporary relief designed to
15 preserve, to the extent appropriate, the current
16 legal framework, until we complete the rulemaking
17 task before us and until we've developed a
18 workable implementation plan.

19 I'd also like to stress that the purpose
20 of these efforts is not to delay implementation of
21 these important OTC derivatives market reforms,
22 but instead to permit an orderly transition to a

1 comprehensive regulatory framework for
2 securities-based swaps. Accordingly, we are not
3 intending to oppose artificial deadlines through
4 these efforts, but instead to put the agency in a
5 position where we can implement these important
6 new securities-based swap requirements in the most
7 efficient manner while minimizing unnecessary
8 disruption and cost to the market.

9 After proposing the key rules under
10 Title VII, the Commission intends to consider
11 seeking public comment on a detailed
12 implementation plan. Commission staff has been
13 working with our fellow regulators and market
14 participants in forums such as this to craft rules
15 and establish implementation timeframes that are
16 reasonable for the various rulemakings and
17 reviewing what steps market participants will need
18 to take in order to comply with our proposed
19 rules.

20 These discussions with market
21 participants are vital to establish an
22 implementation timetable that is workable. We

1 also recognize the importance of obtaining input
2 on the implementation timeline for Title VII.

3 One final general issue that relates to
4 the discussions we'll be having today is the
5 concern expressed by many market participants over
6 the international reach and effectiveness of our
7 proposed rules, particularly with regard to dealer
8 registration. We acknowledge this concern and the
9 request for greater clarity in this area. The SEC
10 staff is actively considering how best to approach
11 this issue including whether we should be
12 addressing these concerns through a separate
13 release focusing more holistically on all the
14 international questions that have been raised.

15 Turning now to our discussions today, we
16 will focus on the core intermediary definitions
17 contained in Title VII. We received extensive
18 comment on the proposed definitions and appreciate
19 the efforts that many of you have undertaken to
20 provide these comments and to meet with the staff
21 of the two agencies. We have an opportunity today
22 to engage in additional discussions focused on

1 many of the issues raised in these comments.

2 I'd like to emphasize that the subject
3 of the roundtable is the dealer and major
4 participant definitions. We recognize that these
5 definitions are linked to a number of related
6 issues, these include issues about how the
7 definitions, as well as how other requirements,
8 will apply to multinational transactions and
9 entities. These also include issues about the
10 timing of implementation. We acknowledge these
11 concerns and request for clarity and have taken or
12 intend to take actions to address these issues,
13 but these issues will not constitute the major
14 focus of the roundtable.

15 With that, let me again thank our
16 panelists for their participation. The insight
17 you bring will be extremely valuable to us as we
18 move forward with final rules on these
19 definitions. And now let me hand it over to CFTC
20 staff for their opening remarks.

21 MR. BERKOVITZ: Thank you, Robert. I'm
22 Dan Berkovitz, general counsel of the CFTC and at

1 the table from CFTC we also have Ananda
2 Radhakrishnan, who's the director of the Division
3 of Clearing and Intermediary Oversight, and Mark
4 Fajfar, who's in the Office of General Counsel and
5 is our team lead for the swap dealer and entities
6 definitions rules.

7 I would also like to welcome and thank
8 the panelists for taking the time to come here
9 today and participate in this panel and offer your
10 thoughts and insights and comments on this issue.
11 I'd also like to welcome staff of both agencies
12 and commissioners of both agencies who may be in
13 attendance today or watching and thank all --
14 everyone in attendance today.

15 I'm going to turn it over to Mark who
16 will give more further remarks on the purpose of
17 today's meeting.

18 MR. FAJFAR: Thanks. First of all we
19 have our technical notes, before we forget. This
20 meeting is being recorded and there's an official
21 transcript being kept that will be available on
22 the websites. For the panelists, the microphones

1 are push to talk. Please turn them off when
2 you're done, and as usual, keep the cell phones
3 and Blackberries off the table. They cause
4 interference.

5 Because the -- I'd like to talk a little
6 bit about the format of the panel, especially for
7 people in the audience and those on the phones, so
8 you understand what we're going to be talking
9 about. We received about 100 -- more than 130
10 comment letters and we have already had roughly
11 100 meetings with industry and other participants
12 to discuss these topics and the primary purpose of
13 the roundtable is really to address those comments
14 and to try and coordinate the different comments.

15 You should understand that we're going
16 to go directly into the topics. We really won't
17 have a lot of time to give background or
18 explanation about the points that we're talking
19 about. Nearly all of the panelists have provided
20 extensive comment letters, so if you were
21 wondering more about what people say you can go on
22 the websites and look at their comment letters and

1 you can find more details there. Sometimes the
2 panelists might refer to what they said in their
3 comment letters and so forth.

4 As Robert said, there are some topics
5 that because of time constraints and to keep a
6 focused discussion, we've talked with the
7 panelists and we're just not going to address, and
8 these include the exception in the swap dealer
9 definition for insured depository institutions in
10 connection with originating a loan -- we'll talk
11 about other things related to insured depository
12 institutions, but not that specific exception --
13 as Robert said, the application outside the U.S.
14 of the definitions, what are the requirements that
15 apply to swap dealers after it's determined and
16 MSPs after it's determined that they should
17 register, and also we're not talking about what
18 are the transactions that are covered by the
19 definition of swap and security-based swap, and
20 that includes, for example, which transactions in
21 the electricity space are swaps. That's an
22 important issue that relates to the entity

1 definitions, but we're not getting into here.
2 Also, you should know, that we've talked with the
3 panelists about the topics that we're going to
4 address and some of the panelists really only want
5 to address certain topics. In fact, most of them
6 are each here to address certain topics, so just
7 because a panelist is not participating in a part
8 of the discussion you shouldn't draw any
9 conclusion from that.

10 And most of all we'd like to encourage a
11 dialogue between the panelists and the staff, and
12 as I said, talk about what the different comments
13 were and how to coordinate them.

14 It wasn't said that Josh Kans and
15 Richard Grant are also here from the SEC and I
16 thought we would just -- if we want to go with the
17 panelists on the first panel, just to introduce
18 yourselves and then we'll go straight to the first
19 topic. So, we want to start with Newedge?

20 MR. NICHOLAS: John Nicholas, Newedge.

21 MR. COTA: Sean Cota, Cota & Cota,
22 petroleum marketers.

1 MR. PROSSER: Ed Prosser with Gavilon.

2 MR. MASTERS: Michael Masters, Better
3 Markets.

4 MR. CHERN: Eric Chern, Chicago Trading
5 Company.

6 MR. WASSON: Russ Wasson, National Rural
7 Electric Cooperative Association.

8 MR. OSTRANDER: Rick Ostrander from
9 Morgan Stanley.

10 MR. FILLER: Ron Filler, New York Law
11 School.

12 MR. OPPENHEIMER: Ron Oppenheimer, I'm
13 general counsel of Veto Inc., and I'm here for the
14 Working Group of Commercial Energy Firms.

15 MR. WALTON: Steve Walton, Bank of
16 Oklahoma.

17 MR. FAJFAR: Okay, so we're going to get
18 right started with the definition of swap dealer,
19 security-based swap dealer. In the statute there
20 are four prongs, we call them, for lack of a
21 better word. They're basically holding yourself
22 in the market as swap dealer, being a market

1 maker, there's a regular business part of the
2 definition, and the last is engaging in activities
3 making you commonly known as a swap dealer or
4 market maker. And we were thinking to start with,
5 the first prong, to start at the beginning, and we
6 sort of grouped the first and the fourth together,
7 the holding yourself out and commonly known are
8 generally the same, and we wanted to discuss
9 starting at the beginning how -- the panelists
10 views of how people make themselves known, and
11 what it means to be commonly known as a swap
12 dealer or hold yourself out as a swap dealer, and
13 in particular, what the relevance of that concept
14 has in swap markets where there's more of a --
15 what we could say thinly traded or thinly
16 executed, the negotiated markets, bilaterally
17 negotiated, and what factors we should look at.
18 Is there anybody who would like to start off with
19 that?

20 MR. WASSON: Mark, if I may, and I'd
21 just throw this out for the consideration of the
22 rest of the panel. When thinking about the word

1 dealer, which is not itself defined, as I know --
2 insofar as I know in the statute, it occurred to
3 me that a dealer has to be suffused with a profit
4 motive, that it's self-evident that a dealer would
5 be in business to make a profit. I mean, I can't
6 imagine an altruistic swap dealer who says that I
7 will take your trade -- I'll take the other side
8 of your trade for a fee, but I'm only interested
9 in recovering my costs. And that's a critical
10 issue for us, that is public power entities,
11 because as you know, electric cooperatives and
12 municipal utilities operate on a not-for-profit
13 basis. And so, you know, we don't have a profit
14 motive, we're not driven by a profit motive, we're
15 end users that hedge our commercial risk in an
16 attempt to protect our members from price
17 volatility and the fuels, interest rates, and
18 electricity markets.

19 So, when we use the term dealer, to me
20 it implies someone who inherently has a profit
21 motive and I just wonder if there's any discussion
22 around that concept. Is there anyone that would

1 disagree with that?

2 MR. FAJFAR: That's a -- another way I
3 would phrase this question, and a lot we've talked
4 about is, are you -- the question is, are you
5 holding yourselves out -- the statute says holding
6 yourself out as a swap dealer, and when it says
7 that, does it mean a swap dealer as opposed to
8 something else as opposed -- somebody who's ready
9 to enter into swaps. What does it mean to hold
10 yourself out as a swap dealer, for example, as
11 opposed to somebody who's ready to enter into
12 swaps? Is that a significant difference? Is
13 there a difference between a dealer and other
14 users?

15 MR. WASSON: I hesitate to monopolize
16 everything but it seems to me, Mark, that if
17 you're holding yourself out as a swap dealer, then
18 colloquially you are -- I mean, we think of people
19 coming in off the street wanting to do a
20 transaction and you as a dealer saying, I'll take
21 the other side of that transaction for a fee. I
22 mean, that's the way I think of it. So if I'm

1 holding myself out as a swap dealer, I would think
2 that I would be open to doing swaps with the
3 general public, you know, with folks that anybody
4 that wants to do a swap. I'll make a market and
5 I'll do that transaction as opposed to
6 occasionally entering into swaps to hedge
7 commercial risk. I see those as two different
8 things.

9 MR. OSTRANDER: Mark, I think it is
10 critical that -- and there's a theme, I think,
11 that runs through all four prongs, actually, which
12 is that a dealer is somebody who's willing to
13 enter into trades on either side of the market at
14 any particular point in time. That doesn't mean
15 they're always doing that. It doesn't mean
16 they're continuously giving two-way quotes, but a
17 dealer is someone who is known in the market as
18 being willing to enter into the buy or sell side
19 of a trade, generally with market participants. I
20 think that is a critical piece of being a dealer
21 and I think that piece actually runs through all
22 the prongs and could help the commissions frame

1 how they think about all the prongs because I do
2 think that element in and of itself is pretty
3 critical.

4 I think the other element is being
5 willing to take risk. I think a dealer is someone
6 who's known in the market as willing to do a
7 trade. If an entity is not taking any risk, I
8 would think that's more of a broker activity than
9 a dealer activity. So, a dealer is someone who is
10 out there willing to enter into trades, buy side
11 or sell side trades, and willing to take risk on
12 those trades. They may flatten their book at the
13 end of the day, they may flatten it over time, but
14 at any particular point in time they would be
15 willing to take risk.

16 MR. FILLER: So, I'm here from the
17 academic side, but I have 35 years of experience
18 in the industry, so I really think it's important
19 for both commissions to maybe take a step back and
20 as Russ and Rick just talked about is really to
21 define what is a dealer.

22 In the futures world, we don't have

1 dealers, we have brokers. We're agents. You do
2 have dealers in the security side so you almost
3 have to look to the securities world to see what
4 is their definition of a dealer and whether that
5 same definition can apply in the swap area. So, I
6 mean, I think one of the critical aspects for both
7 commissions is to look at and define what is a
8 dealer, and as Rick just said, it really applies
9 to all four prongs. It's just not holding oneself
10 out, it's in the market making activity and
11 regularly entered into the business and I think
12 it's important to come up with a very specific
13 definition of dealer with respect to swaps. So,
14 that would be, to me, the most important starting
15 point and then dealing with the holding oneself
16 out aspect, I agree with Russ and Rick, it's
17 really those firms that are willing to take either
18 side of the market. Either they're going to be
19 the long on the swap or the short on the swap, and
20 to be honest, we know those 15 to 25 firms out
21 there that actively play the role of swap dealer.
22 I mean, they do 90 plus percent of the business.

1 The other critical issue for the
2 commissions to deal with, in not only holding
3 oneself out, but in the entire panel this morning
4 -- both panels -- is who else should be falling
5 within that definition of a swap dealer? We know
6 the 25 firms or the 30 firms or the 40 firms who
7 are actively involved in holding oneself out,
8 taking both sides, but they all deal with hundreds
9 or tens of thousands of counter parties. Is that
10 the intent of Congress with Dodd-Frank to go after
11 the other counter parties? Do they fall under the
12 definition of major swap participant? Or do they
13 fall within the exception?

14 So, I think it's important for the
15 commissions to not only define what is a dealer,
16 but also to provide or establish certain specific
17 exceptions or exemptions from the definition of
18 swap dealer as well.

19 MR. WALTON: Could I? I'm here
20 representing a regional bank and I think that my
21 position and our concerns are similar to those of
22 banks of medium and small size throughout the

1 country that make loans to people who use hedging
2 as a means to minimize their risk.

3 I think there are two things that from
4 our standpoint are important here, and the first
5 is the issue that was just addressed about clarity
6 and safe harbors. From the standpoint of a bank,
7 we can't look at the swap dealer definition just
8 in terms of its CFTC and SEC implications. Under
9 the push out rule, as adopted, if a bank becomes a
10 swap dealer, other than for interest rate or
11 currency transactions, if it inadvertently becomes
12 a swap dealer, it becomes ineligible to receive
13 Federal Deposit Insurance for its deposits, for
14 its people who use the bank, and can't use the
15 Federal Reserve window. Those are two fundamental
16 elements of being a bank. You're basically out of
17 business if you don't have FDIC insurance for
18 people who have a checking account at your bank
19 and you're out of business if you can't use the
20 Fed window.

21 So, from our perspective, and I think
22 that of most banks, clarity is essential here

1 because to the extent that there is, you know,
2 general guidance about generally what it means to
3 be a dealer, most banks will have to stay miles
4 away from anything that might legitimately be
5 characterized as swap dealer activity because
6 being wrong potentially means being out of
7 business.

8 So, swap dealer activities for banks,
9 which are a critical component of this business
10 for small agricultural producers and energy
11 producers in particular, is critical. We need
12 clarity and frankly we think the proposed rules,
13 though helpful in giving direction and guidance
14 about what it constitutes to be a dealer, is
15 simply insufficient for an insured depository
16 institution that faces the death penalty if it
17 gets it wrong once in how it deals with the swap
18 dealer issue.

19 The second thing I would say in the bank
20 context is, though I think everyone feels that
21 there is a general understanding of what a dealer
22 is in the day-to-day large swap markets, banks

1 regularly, as part of making loans to small
2 producers, enter into hedge transactions with
3 those customers, not as a dealer, but as an
4 accommodation as part of making that loan.

5 If we have a farmer in Kansas who wants
6 a loan secured on his wheat, we want him to hedge,
7 he wants to hedge. When we make that loan and
8 take that hedge, we immediately lay the hedge off
9 on the market so that we as a bank are taking no
10 risk. This is something the Federal Reserve and
11 the OCC have permitted banks to do for decades and
12 it's considered a brokerage activity, an agency
13 activity, because we are transferring the risk
14 directly to the market. That small farmer doesn't
15 want to go to Chicago or New York and establish a
16 relationship, and we as a bank are in a position
17 to say to that customer, well, if your wheat goes
18 up in value, since we have a security interest in
19 your wheat, and your mark-to-market on the hedge
20 goes down, you don't have to post collateral
21 because we're money good, but if you get into a
22 position where banks have to treat themselves as

1 dealers and exit this business because of the
2 risk, that customer, who is -- has his wheat gone
3 up in value by a million dollars but his hedge is
4 now negative \$500,000, if he's dealing with a swap
5 dealer, he's going to have to post margin because
6 the swap dealer's only relationship with him is
7 that negative mark- to-market.

8 So, that little farmer, is going to have
9 to borrow to post margin, which he does not have
10 to do today if he deals with a bank only. The
11 commercial end user exception from posting margin,
12 which I think you've done tremendous work to
13 develop, is meaningless to a small farmer or
14 energy produce if he has to transact, on one hand
15 with the bank for his loan, and on the other hand
16 with the market as a dealer.

17 So, in the context of the dealer
18 definition, my concern for banks is that we are
19 accommodating customers in a transaction that
20 transmits the risk to the market. That's a
21 brokerage transaction and we would like clarity on
22 that.

1 MR. FAJFAR: Let me ask, so that I think
2 those comments really tee up a very good question.
3 That's a perfect -- let's take that example, the
4 small farmer who's going to take out the loan, now
5 they want to hedge that loan. So, it seems that
6 the consensus, so far, is that if the farmer chose
7 to go to one of the 25 large banks to get the
8 hedge, the bank would have to register as a swap
9 dealer and the farmer would have to post margin.
10 If, however, the farmer chose to get exactly the
11 same swap from his commodities supplier, the same
12 person he's dealing with commodities, he would not
13 post margin, the commodities firm would not have
14 to register as a swap dealer because it's in the
15 business of handling this commodity, and if it
16 were to go to a regional bank, the same regional
17 bank that it's getting the loan from, then again,
18 not a swap dealer because it's getting the loan,
19 it's merely being accommodated, no need to post
20 margin.

21 So, it seems that from the customer's
22 perspective, those three swaps are identical, but

1 because of the way the regulation is written and
2 sort of the history of how the swap market has
3 developed, they would in fact be very different.
4 Is that the consensus on the group?

5 MR. WALTON: I'm not sure. I would say
6 this. I think it's different from the vantage
7 point of the different people who transact with
8 that farmer. If your only transaction with the
9 farmer is to take his hedge transaction and he's
10 protecting the price of wheat and wheat goes up,
11 and you don't have a security interest in all of
12 his productions, so you're not benefitted on that
13 relationship. All you have is the fact that when
14 you do the mark-to-market of his hedges, he's
15 down, and he's a small guy. You're going to
16 require that he post margin. For him to do that
17 in that context, he will then turn to his credit
18 facility and he will borrow money and if he has
19 the hedge where he has the loan, the bank -- we do
20 this every day, with hundreds of borrowers --

21 MR. FAJFAR: I just want to -- I think
22 we can address it, but you're saying that we

1 should write the swap dealer definition to get to
2 a certain policy result about how people have to
3 post margin? Is that basically --

4 MR. WALTON: No, I'm pointing out an
5 implication of the swap dealer regulation if
6 banks, in performing this basically -- assisting
7 that person going to the market category of
8 transaction effectively have to exit the business
9 as swap dealers, so that they cannot obtain that
10 service from the bank that's also making the loan,
11 because, again, if a bank's a swap dealer, the
12 bank's out of business, so the bank won't be a
13 swap dealer.

14 If the customer has to get the swap from
15 door number one and the loan from door number two,
16 you can't look at the relationship on an
17 integrated basis. There's no one there to look at
18 it on that basis. You're going to look at his
19 mark-to-market on the swap, for which he'll post
20 collateral and he will borrow on the lending
21 facility. The net result is, people who are not
22 borrowing to post margin today, because they get

1 the service from their banks, will be borrowing to
2 post margin tomorrow because they have two
3 distinct relationships.

4 MR. RADHAKRISHNAN: Let me see if I can
5 clarify this because the Commission has proposed
6 margin rules for uncleared swaps and in the
7 proposal the Commission did not seek to require
8 dealers to collect margin from commercial end
9 users, so I don't know if you're aware of that --

10 MR. WALTON: I am.

11 MR. RADHAKRISHNAN: Okay, so, but what
12 you're saying is this, I'm a farmer, I come to
13 you. I borrow money. Why do I borrow money? So
14 I can go and plant?

15 MR. WALTON: Yes.

16 MR. RADHAKRISHNAN: Okay. What's your
17 security interest?

18 MR. WALTON: The crops.

19 MR. RADHAKRISHNAN: The crop. So, then
20 what else do I do with you? I do a swap -- do you
21 do a swap or do I do a swap?

22 MR. WALTON: You hedge your transaction

1 with me as your counterparty for the swap. I then
2 put it into the -- you may be a dealer because you
3 do a swap with me, right? So, I know we're not
4 supposed to talk about the IDI exception, but I'm
5 wondering whether the IDI exception may benefit
6 you, but --

7 MR. RADHAKRISHNAN: No.

8 MR. WALTON: It will not. Okay, so
9 let's assume it does not. So, looking at it from
10 my perspective, even if you're a dealer, the
11 Commission is not proposing to require me to put
12 up margin with you. In fact, all the Commission
13 is suggesting is that we have a -- some sort of a
14 credit support arrangement. And whether I have to
15 post margin with you is a function of, you know,
16 the credit support arrangement that I have with
17 you.

18 So, I'm trying to understand how I'm
19 worse off.

20 MR. RADHAKRISHNAN: Okay, it's because
21 you don't require, from a regulatory standpoint,
22 that the commercial end user post margin, the

1 self-interest of the swap dealer whose only
2 relationship is taking the hedge, we will require
3 him to take margin. If I'm the farmer and hedge
4 and tomorrow the price of wheat goes up, and so my
5 mark-to-market with you, my swap dealer, that's
6 the only relationship, shows that I'm down
7 \$100,000 on my swap, and you have no other
8 relationship with me, it really doesn't matter
9 whether the CFTC requires you, as a swap dealer,
10 to take margin, you will take margin to protect
11 yourself against the risk that I have a loss.

12 MR. WALTON: Fair enough. But if that's
13 the case, what difference does it make whether we
14 make you a deal or not? You're going to collect
15 margin anyway, right? That's what you're saying?

16 MR. RADHAKRISHNAN: No, what I'm saying
17 is if we, as a bank, become a swap dealer when we
18 enter that trade, we won't take that trade because
19 if we are a swap dealer, we're out of business as
20 a bank. Banks will stop providing that service
21 and the bank is in a unique position that it can
22 say, since I do both the loan and the swap, I

1 don't have to take margin when you swap goes down
2 because the collateral for my loan has
3 correspondingly gone up.

4 MR. WALTON: Right. You say you're
5 going to be out of business because --

6 MR. RADHAKRISHNAN: Under the push-out
7 rules --

8 MR. WALTON: Oh, okay.

9 MR. FAJFAR: I think we're going to have
10 to move on because people use swaps for a lot of
11 different things. So far we've talked about swaps
12 in connection with loans and we'll just -- we
13 really have to avoid getting into the specific
14 business purpose that each business uses swaps
15 because there is about 30,000 end users, so, I
16 think we'd like to move on to the market making
17 point, and some of the same points will come up --

18 MR. FILLER: Mark, may I just make one
19 other point before we get to the specific on
20 market making, and Ananda raises a very important
21 point for the commissions to consider, and it's a
22 policy argument that is very difficult to address

1 but you need to consider, and that is, swaps have
2 always been "a bilateral or unclear world." Dodd-
3 Frank, and your regulations, are moving swaps to
4 the traded, clear world, but it's not there yet.

5 MR. FAJFAR: Right.

6 MR. FILLER: And it may be six months,
7 it may be a year or two years before we get to
8 that environment. Your swap dealer definition is
9 coming out this year, well before we get to the
10 "traded or cleared" environment, and how do firms
11 that deal with this transition period -- because
12 if you start to clear swaps, as Russ just
13 mentioned, on the point of view of, well, whether
14 I do futures, which is margin, or I do clear
15 swaps, which is margin, and how you finance that,
16 because it is a hedged security agreement
17 financing arrangement, what do we do between now
18 and that point until we get to the cleared
19 environment, which is a little bit different than
20 the current bilateral world, and what -- which
21 firms qualify for a swap dealer now who may not be
22 in the cleared world is a very difficult issue and

1 policy argument for the commissions to deal with.

2 MR. FAJFAR: Right. Okay. Thanks. And
3 the market making tasks, the thing I wanted to get
4 to is, you said, and a lot of the commenters have
5 said, that a dealer is somebody who's willing to
6 take either side of a trade, basically at any
7 time, and it was also, I think, putting aside the
8 cooperatives, I think everybody else on the table
9 would agree they do not do swaps unless they make
10 a profit. So, take it for a given that if you're
11 in a profit making business, you're using the swap
12 to increase -- to have a business benefit.

13 So, the question is, if we defined --
14 there's two questions I have, first of all, if you
15 said a dealer is somebody who's willing to take
16 either side in order to make a profit, are we sure
17 -- is everyone here sure that they could live with
18 that as the definition? Because I think a lot of
19 non -- a lot of firms outside of the 25, top 25,
20 would do a swap with a counterparty if it were a
21 given that they were going to profit from it and
22 these counterparties were there ready to do the

1 swap.

2 And also, you were saying that the --
3 this two- sided definition runs through the whole
4 statute, but should we view the four prongs
5 separate? Is there a difference between being a
6 market maker and being -- holding yourself out as
7 a dealer or being in the regular business of
8 entering into swaps? Are we saying that the four
9 prongs are really just sort of facets of the same
10 point?

11 MR. CHERN: I think it actually falls
12 (inaudible), Mark. I agree with the point of it
13 being one part of the issue being, you know, for
14 someone to hold themselves out as a dealer. It
15 means part of it is that they mean -- that they
16 will take either side at any given time. I think
17 that's necessary but not sufficient for the
18 definition.

19 I find myself asking, hold themselves
20 out as a dealer to whom? You know, if you have
21 traditional market maker over the last several
22 decades trading on the floor in one of our

1 exchanges somewhere, which is where my firm
2 started and where a lot of the liquidity providing
3 firms started, you know, those firms are hardly
4 swap dealers if you think about it. They're on a
5 floor, they're holding themselves out as market
6 makers, I suppose, but to whom? To brokers in the
7 pit. To maybe the intermediary that's
8 representing a customer. They're certainly
9 willing to take either side of a transaction at
10 any given moment. That is sort of a definitional
11 aspect of providing liquidity. They certainly are
12 not touching a customer. They're not facing off
13 one-on-one with a customer. They're not holding
14 customer funds, they're not structuring deals,
15 they're not -- there's no sort of customized
16 products that are being structured to meet the
17 needs of a farmer somewhere or a cooperative of
18 other, so I think that we need to be thoughtful
19 about how we look at those definitions. I think
20 that certainly, I agree, you know, swap dealers
21 are certainly holding themselves out as dealers.
22 In doing so, they are willing to take either side

1 of the market.

2 When I think about the definitions and I
3 think about really the intent behind Dodd-Frank
4 and all of the four prongs, really what we are
5 talking about is the intent to take as much of the
6 trading that was done in a nontransparent,
7 non-cleared, non-standard world, and put that
8 somewhere where the regulators would be able to
9 see it and understand it and measure it. And I
10 think that if this definition of swap dealer is
11 too broad what we're going to find is that the
12 impact of that will be less diversity in the
13 marketplace and people who find themselves making
14 a choice to be a swap dealer or not are certainly
15 going to be exiting businesses that they already
16 were in otherwise.

17 MR. KANS: Eric, if I could ask a follow
18 up question, though, about that. If your
19 implication is that to be a dealer is not enough
20 to have two-sided quotes and be holding yourself
21 out at any time, you have to do something more,
22 something with a customer, something structuring,

1 what exactly -- what is the limiting principle?
2 How much more would you have to be to be a dealer?
3 MR. CHERN: Okay, so you're asking -- by
4 my reason you're saying, what more -- what other
5 activities is a swap dealer doing than what I'm
6 saying should be below that level? I think that,
7 you know, if you look at -- take my firm as an
8 example. Everything we trade is traded centrally,
9 it's cleared, it's standardized, it's transparent,
10 it's fully regulated, there's a broker-dealer by
11 the SEC and everything we do on all the futures
12 exchanges, the CFTC has full purview over. So, I
13 think that when you get into a position where you
14 are dealing with customers and structuring any
15 sort of nonstandard, customized, bilateral
16 agreement, so I think any one of those aspects, if
17 it's customized, it's not standard. If you're
18 dealing with a customer, so it's not cleared, it's
19 a bilateral agreement, if it's not transparently
20 traded, so if there's not, you know, an open
21 competitive market place. I think these are all
22 aspects. I think holding any sort of customer

1 funds, I think, is another aspect.

2 A lot of my competitors, and my firm
3 included, we don't do any of that. When I think
4 of a dealer, that's exactly what I think of, is
5 someone who is facing off with a customer to

6 provide a necessary service to that customer,
7 that's just not what we do.

8 MR. BERKOVITZ: Can I ask the question a
9 slightly different way? It was -- it's been
10 embedded in several of the questions and several
11 of the answers. If we have an objective test, I'm
12 assuming that we could establish an objective test
13 such as what we're talking about, two-way, always
14 ready, then to what extent does -- we're talking
15 about additional factors -- does motivation -- the
16 underlying motivation for doing that, is that
17 relevant? Should this be just purely objective
18 test if somebody on the outside could say, well,
19 this person is always ready to make quotes on both
20 sides. Some parties do that as an adjunct to some
21 other business. Some parties, that's the sole
22 reason they're doing it. And should those other

1 -- like the motivation or the business model of
2 the firm that's engaging in this activity be a
3 relevant factor in terms of whether that activity
4 is in fact dealing?

5 MR. OPPENHEIMER: I think --

6 MR. MASTERS: I was just going to make
7 one point, or two points. I mean, the statute is
8 pretty clear. It's disjunctive in terms of, you
9 know, there's four parts, so I mean, it's any one
10 of those, but then the other point is, is with
11 regard to, you know, the for profit entity, I
12 mean, you know, I think you've got to be careful
13 in the sense of, while a swap dealer -- if they
14 were exclusively a swap dealer and they were just
15 doing a for profit enterprise I could see that
16 issue, but what if you're another kind of
17 financial institution and used the swap dealer
18 part of your business as sort of a loss leader, if
19 you will, and you tie that together and sort of
20 like that makes things a little more complex in
21 terms of a pure, you know, for profit. You tie
22 one thing to the next, oh, no, this isn't an area

1 that we make any money in, but the other part of
2 the business we do and we, you know, we get
3 business that way. So, anyway.

4 MR. WASSON: Of course, I presume that
5 you wouldn't do the loss leader solely. I mean,
6 you would have to tie it to a profit making
7 activity, otherwise you wouldn't do it, I presume.

8 MR. MASTERS: That's right, and I'm just
9 suggesting the Commission to be aware of that sort
10 of avenue.

11 MR. WASSON: Yeah. And I think the
12 question about taking both sides of a trade is
13 interesting for us because, I mean, we don't
14 trade, you know, we're hedging, and so it seems to
15 me that the essence of being a swap dealer
16 involves trading, you know, or dealing, or
17 speculation.

18 MR. PROSSER: I do think that motivation
19 certainly should be a part of how you look at
20 this. We are a commodity supply chain management
21 business. We access the swap market infrequently
22 because of specific risks, but I do have buy side

1 risk at some point and sell side risk at some
2 point, so I am on both sides of the market. I am
3 certainly not making markets, but because I hedge
4 a producer on one side and a consumer on the other
5 side, I enter the market looking for both sides of
6 the marketplace, and certainly the activity that
7 we create through, we don't feel like should be
8 defined as dealing in these instruments but we do
9 need both sides because we are the merchant.

10 As we move our physical commodities
11 through the system, sometimes I need to hedge the
12 long side, sometimes I need to hedge the short
13 side, either side of the market, but certainly not
14 making markets in either of those and we don't
15 feel like that activity should get caught up.

16 MR. FAJFAR: How do you distinguish that
17 from -- I mean, because from a customer's -- a
18 customer is always only interested in whatever
19 they're interested in, and then there is a source
20 that's there serving both sides of the -- how do
21 you distinguish that from a dealer?

22 MR. PROSSER: Well, again, I think that

1 this idea of motivation -- my motive is not to go
2 take bid ask spread from the marketplace by making
3 a market with outside parties on swaps. My
4 motivation is to avert risk in my supply chain.
5 Some of those have to be on buy side, some of
6 those have to be on the sell side, but my
7 motivation is not the transaction -- trying to
8 take profit from the transaction of dealing with
9 these swaps, it is to try to use the swaps to risk
10 -- to avert risk inside of my supply chain. So I
11 do think that motivation gets at the heart of
12 those that are trying to deal in swaps and those
13 that are certainly just using them as instruments
14 of hedging.

15 MR. OPPENHEIMER: The word we've heard a
16 lot around the table in every context we've
17 discussed so far is customer, okay, and that
18 connotes a motivation. Are you in the market
19 because you want to serve a customer base or are
20 you in the market, as was just said, for the
21 purpose of your own hedging needs or to take your
22 own position in the market? So, motivation is

1 clearly a part of this and if your motivation is
2 customer based, that's when you start looking at a
3 dealer.

4 So, we really do have to continue to
5 focus on that aspect of dealer activity, again,
6 customers, you're making a profit, it all ties
7 together in that respect.

8 The other point I want to say about
9 motivation is that we use the words, or you used
10 the words in the proposal, facilitate or
11 accommodate, okay. Facilitate or accommodate has
12 to be the purpose for which somebody has gone to
13 the market, not merely a consequence. So, if
14 there's an active trader in the market, whether
15 it's because we're in the supply chain, you've got
16 both sides there or you're taking positions,
17 you're just a trader, and I know I'm happy staying
18 away from the phrase dealer-trader distinction
19 because that's a little bit loaded, but the fact
20 is there is a difference between people who are
21 ready to take a trade as a trader because they
22 have an interest in that position, and somebody

1 who's there because they want to serve a customer
2 base.

3 So, the point being there is that if the
4 facilitation or accommodation is merely a
5 consequence of your being in the market, that's
6 not swap dealer activity. If it's the purpose for
7 you being in the swap market, it would be.

8 MR. NICHOLAS: I think that it's
9 important to focus on the distinction between
10 dealer and broker and Ron touched on that topic,
11 even within the customer space, although obviously
12 both dealers and brokers deal with customers, and
13 in particular I think the concern of ours is the
14 third prong of the test which is entering into
15 principal transactions in the normal course of
16 business.

17 I think that if we look at the security
18 space, for example, where there is a distinction
19 between brokers and dealers, brokers often enter
20 into principal transactions where they're either
21 the initial trading counterparty on a trade or the
22 accept a given for clearing purposes and

1 ultimately are acting in a principal capacity, but
2 they're solely acting for customers. In other
3 words, they're responding to customer orders,
4 they're not taking risk because the transactions
5 are usually riskless principal, and I think that
6 there are brokers out there who are unsure as to
7 whether they fall into the dealer definition
8 primarily based on that third prong, and I don't
9 think they should. I think customer-driven,
10 riskless principal activity does not fall into the
11 dealer definition even though you're acting in a
12 principal capacity.

13 MR. RADHAKRISHNAN: Can I make two
14 observations? One has to do with this notion of a
15 customer, and this everybody tells me I'm wrong.
16 It's entirely possible that a bank could be a
17 customer because it could engage in the swap to
18 hedge whatever risk it takes in some other
19 activity. So, I'm worried that if you take that
20 notion too far, nobody will be a dealer because,
21 you know, the bank will say, all I do is I am
22 basically hedging my own risks, so I'm a customer,

1 therefore I'm not a dealer.

2 MR. OPPENHEIMER: I think that's really
3 not a concern and it goes back to something I was
4 trying to get in to say before about holding
5 oneself out. It's really almost ironic or funny
6 as you look at it, but I think you don't have to
7 worry so much about the holding oneself out
8 because the firms that want to do customer
9 business are going to register as swap dealers
10 because they want to hold themselves out as doing
11 that business to gain the customer business. So,
12 that bank, if they're looking to do swap dealer
13 business, they're going to hold themselves out and
14 register because that's sort of the sine qua non
15 of being able to go out to the marketplace and
16 say, here I am. And I don't think you need to
17 worry about that. If there was a bank that only
18 turned around and hedged its loan portfolio or
19 whatever, then they could be a customer.

20 MR. RADHAKRISHNAN: So, what you're
21 saying is, let people who want to become dealers
22 register as dealers instead of the Commission

1 going after people saying, you know, you fall
2 within the definition, you've got to register.
3 That's --

4 MR. OPPENHEIMER: I'm saying that I
5 think there's an excess of concern about that firm
6 at the margin, that you're going to get the firms
7 who are engaged in dealing activity, certainly the
8 top 10, 15, 25 that Ron was referring to before,
9 and probably many others who do want to be engaged
10 in that business coming forward and saying, here's
11 my ticket, this is me holding myself out, let me
12 register because now I want to go solicit
13 customers. You've got a lot of stuff at the
14 margin where we're having a hard time
15 differentiating between market making and dealing
16 or activity that could be market making or dealer,
17 trading activity that might in some contexts look
18 like dealing, and I think you don't really need to
19 worry about that.

20 You know, another point Ron made about
21 we're in a transition phase, I think that counsels
22 to the Commission starting with a very narrow

1 definition that captures the top 25, 30, 50, the
2 ones who say I want to do customer business, here
3 I am, and then let the market evolve, let's go to
4 cleared trading, SEF trading, that will take out a
5 lot of activity that currently is dealing activity
6 where people have been avoiding the futures
7 markets, doing a swap, and letting somebody else
8 go to the futures market for them.

9 A lot of that business will fall away
10 because of the clearing requirement. After it
11 does, then you can consider do we need to expand
12 the market because we've missed a segment of
13 dealers who really should be regulated.

14 MR. FAJFAR: I'd like to ask -- a lot of
15 points have been made. I would wonder where the
16 authority in the statute is to do that. But we're
17 going to talk about the de minimis standard in the
18 next panel, so let's save that, but how would we
19 respond to somebody who said, no, the dealer
20 definition doesn't contain any reference to
21 systemic risk or important dealers or people who
22 are traditionally known as dealers, and what would

1 be the authority to say, well, we're going to
2 capture 90 percent of the dealers and the other 10
3 percent are not going to be capture, I mean, aside
4 from the de minimis. Well, we'll talk about de
5 minimis later. What would be the legal authority
6 to do that?

7 MR. OPPENHEIMER: Well, I mean, I think
8 we've all agreed -- the Commission, I think, said
9 it explicitly in the release, I'm not 100 percent
10 sure -- that you tie prong three to exception C,
11 right, the regular business exception, and the
12 activities we're talking about that are at the
13 margin are things that the Commission can easily
14 interpret what regular business means and work
15 those things in and manage that process.

16 MR. FILLER: The specific section is
17 712(d), when you have -- it gives you broad
18 authority to exercise judicial prudence in
19 establishing your regulation as we're dealing with
20 any of the definitions, so the statutory issue to
21 me would be 712(d) that you could provide comfort
22 for. And I think what you're also hearing a lot,

1 in different ways, I mean, from the dealers, the
2 banks, whatever, is what is this carve out for a
3 hedge? Those who gauge in swaps from a hedge or
4 reducing a mitigating risk perspective, should
5 there be an exemption for that? And I think that
6 is going to be a very important, again, policy
7 argument for the commissions to consider, is
8 should there be a hedge exemption and what should
9 the terms of that hedge exemption be, and you've
10 got to be careful because you can't do 100 percent
11 test.

12 As Russ mentioned, there's a profit
13 test. Well, you can't do 100 percent profit
14 because there may be circumstances where I am
15 hedging 95 percent of the time or 98 percent of
16 the time, but I might do one transaction that's
17 "for profit" and we cannot allow -- so there's got
18 to be a predominant or primary type intent to seek
19 the profit as opposed to 100 percent test.
20 There's got to be some carve out because
21 unfortunately the definition of bona fide hedging
22 was last amended in October of 1978. The market

1 has changed in the last 33 years and so the term
2 hedge is, if you go to the hedge exemption, you've
3 got to be careful about making it a 100 percent
4 test.

5 MR. FAJFAR: I think -- I'm sorry.

6 MR. MASTERS: Well, I was just going to
7 make one point on the hedge. Whole hedge
8 exemption, which is a bigger, broader point. So,
9 I run a hedge fund and there's nothing in my
10 portfolio that I can't claim is not a hedge on
11 something, so you have to draw the line somewhere,
12 and the statute is pretty specific on narrowness
13 of hedges to business risk. It's sort of
14 Pandora's box. I mean, you can't just open it a
15 little bit. So, you know, with regard to the
16 other point that Ron was making about, you know,
17 having customer business or -- and sort of -- and
18 I think Ed was making as well -- on intent,
19 there's a lot of companies where there's blends of
20 this, where you've got part of the company doing
21 one thing and part of the company doing another
22 thing. And so what you don't want to do is open

1 something up so the part of the company that's
2 really a swap dealer, even though there's another
3 part of the company that's doing legitimate
4 business risk, gets sort of a blanket exemption,
5 and so that's -- I think that's a really important
6 point.

7 MR. FAJFAR: I'd like to ask, especially
8 on the -- we've talked about having a motivation
9 test and also a profit test, so, for you to think
10 about -- so what kind of books and records
11 requirements would we have? How would you, if you
12 came and we brought a case and thought you were a
13 swap dealer, how would you show that your
14 motivation is to profit from the underlying, not
15 from a bid ask spread? What -- how would that
16 actually -- how would that rule read and then how
17 would it be implemented? Because really the
18 reason we have a rule is for two purposes, one is
19 for people to read it and understand if they have
20 to register, and the other is for the court to
21 read it and understand if they have to register.
22 So, how would that really work that that would be

1 -- would you be happy if we said a swap dealer is
2 a person whose motivation is to profit from a bid
3 ask spread rather than underlying, now you go
4 figure out what that means in each instance?

5 MR. OSTRANDER: Well, I guess I'm a
6 little lost in how profitability has to be from
7 bid ask spreads or not, but putting that aside, I
8 think some things that are very important to keep
9 in mind here, if you're talking about how do you
10 prove you're not a swap dealer later on, maybe it
11 would make sense for the commissions not to be too
12 prescriptive at this point in time as to what sort
13 of evidence would get you out. I think it is very
14 important to create safe harbors, perhaps, that
15 could be -- people could fall within, but I would
16 have thought the concept here is not to define
17 precisely what activity brings you over the line
18 exactly, but rather what are the concepts that
19 make you a swap dealer, what are some good safe
20 harbors so people can be sure they're out of this.
21 And there will be cases on the margin.

22 And on that side I would also urge the

1 commissions to -- as has been suggested earlier,
2 is to go a little bit slowly here, let the markets
3 adjust to what this definition means, there will
4 be entities, Morgan Stanley is certainly one of
5 them, that are going to register as swap dealers
6 but there are a lot of entities, I think, on the
7 margins that aren't going to be sure. The burden,
8 I would think, should be on the commissions to
9 show that an entity is an unregistered swap dealer
10 rather than for an entity to have to prove it's
11 not -- not a swap dealer. Of course, if you got
12 into a situation, you would want to bring out
13 evidence, but I don't know if it makes sense today
14 to specify exactly what that evidence would be or
15 what form it would take. I think that's going to
16 have to come out over time as we get used to what
17 these definitions mean.

18 MR. FAJFAR: How does that -- a lot of
19 people really wanted very clear -- a very clear
20 definition, very bright line. Many commenters
21 said that, almost universally.

22 MR. COOK: Maybe if I understood you

1 correctly, Rick, and I would be curious if other
2 people agree with this formulation, you tell me if
3 I get it wrong, is that you could have a general
4 standard about what is or is not a swap dealer or
5 securities-based swap dealer, but that wouldn't be
6 necessarily very precise and prescriptive, but
7 then you would have safe harbors for people, who
8 you say, well, you don't even need to worry about
9 that if you fall into this category. So, one
10 example would be --

11 MR. OSTRANDER: Exactly.

12 MR. COOK: -- the traditional, on the
13 securities side, trader-dealer distinction. It's
14 a list of factors, developed no action letters,
15 people who are on the securities side of the world
16 sort of know how it works, people who aren't, find
17 it very confusing and frustratingly vague, I would
18 suspect, but that might be -- something like that
19 might be the general standard, but then give
20 people clarity that you don't have to worry about
21 it if, and de minimis would be one tool,
22 obviously, but there would be other tools.

1 MR. OSTRANDER: And I think you have
2 definition authority to do all that. You could,
3 for example, say, entities that are commodity
4 pools or that are 4(d) act funds or exempt 4(d)
5 act funds could be presumed not to be dealers. I
6 think you can find, I'm sure there are a number of
7 examples out there where you could start to create
8 either safe harbors or presumptions, perhaps
9 rebuttable presumptions, about categories that
10 would give the market some certainty, because I
11 think we really are talking about the margins here
12 and, as we say, most of the big dealers know it
13 and if you created some clean, safe harbors, I
14 think most of the people who aren't on the line
15 would get a lot of comfort from that.

16 MR. CHERN: Yeah, I do think that
17 there's some specific language you could have out
18 there. There were a couple of suggestions in
19 there from Rick. I think that, you know, if we
20 really -- even just listening to this
21 conversation, it's very clear the problem is
22 complicated and it's getting more complicated, not

1 less, and I think that if we really want to solve
2 it, we have to simplify it a little bit. If we
3 look back at what happened in 2008, we had some
4 very concentrated risk in a few very large parties
5 that were trading in a way that the regulators
6 didn't have a view of, simply stated, and I think
7 if we say, okay, so the intent of this
8 legislation, this piece of it, is to give the
9 regulators a view over those activities that they
10 didn't have a view of before. And so now you can
11 say, okay, so how do I get back to your question,
12 if you have entities that are trading 100 percent
13 cleared, standard contracts, centrally traded,
14 this -- none of this has anything to do with
15 creating systemic risk.

16 On the contrary, in fact, what we really
17 want to do is to increase the number of liquidity
18 providers in that space, we want to increase the
19 diversity, we want to reduce systemic risk by
20 having more people competing to make markets.
21 Now, that might not be great for me if I have more
22 people competing with me, but it's going to be way

1 better for the markets. It's going to be a
2 healthier market if we have less concentrated
3 risk, more people competing to provide liquidity,
4 more efficient markets for people like Russ.
5 That's what I think, if you simplify the problem,
6 I think that that really gets to the heart of it.

7 MR. NICHOLAS: Yeah, I agree with that
8 100 percent. I mean, I think we need to get back
9 to the Congressional intent behind Dodd-Frank,
10 which I think is transparency and the reduction of
11 systemic risks. So, I think we really, in
12 crafting a definition of dealer, we need to think
13 about and focus on those activities which create
14 risk. And to the extent that an intermediary or
15 an end user or whatever is involved in a swap
16 activity that doesn't create risk, I mean, I think
17 the presumption should be that that's not dealer
18 activity.

19 MR. FAJFAR: Can I just follow up on
20 that? Now, do dealers create risk? Is that
21 clear?

22 MR. NICHOLAS: I think that dealers take

1 risk, absolutely, they take directional positions
2 and -- yes.

3 MR. COOK: I think the last two comments
4 are sort of saying in a way, taking us in a
5 direction I wanted to explore a little bit, which
6 is we've been talking about the definitions, to
7 some extent, as if they're kind of this abstract
8 quantity, like, are you a dealer, aren't you a
9 dealer, how are we going to define it, but really,
10 to what extent should the way we craft the
11 definition be informed by what it is we're trying
12 to achieve in -- and one of the ways you can think
13 about that is, well, what are the requirements
14 that apply to a dealer, right, and I know we're
15 not talking about the substantive requirements in
16 detail, but there are certain substantive
17 requirements of being a dealer, including business
18 conduct requirements, risk management
19 requirements, internal controls, reporting, and
20 that's a little bit more granular than the big
21 Dodd- Frank systemic risk reduction, right? So,
22 one of the ways to think bout whether someone

1 should be a dealer is, well, are they -- would it
2 be -- is there a public policy reason to subject
3 that entity to those sorts of rules, right? You
4 only care about being a dealer depending on what
5 the rules are and the only reason to impose that
6 status on a firm is to make them subject to those
7 rules.

8 So, it's kind of hard to divorce the
9 conversation from what it means to be a dealer, I
10 think, I'd offer that for a comment. And if
11 that's the case, then I think you have to go back
12 to some of the conversation we've been having,
13 like, what if I'm only dealing with two sides and
14 I'm hedged. Well, that might deal, to some
15 extent, with risk-type issues potentially, but you
16 still might be dealing with customers where one
17 could still argue there is a basis for having a
18 customer business conduct type of standard in
19 place.

20 But I'd be interested in hearing people
21 relate their ideas about where we should draw the
22 line to what it means to be a dealer and why or --

1 why is it a good thing if you want to be outside
2 the box, why you shouldn't be subject to business
3 conduct or risk management tools and the like.
4 And for those who are inside the box, why should
5 they be? Because to me, that's kind of the
6 regulatory objective in drawing this line.

7 MR. MASTERS: Bob, I would just -- I
8 agree with that pretty much wholeheartedly. I
9 mean, it's not just systemic risk. Business
10 conduct is a key part of Dodd- Frank and, you
11 know, one of the reasons, for instance, you've got
12 the special entity rules because we know some of
13 the things -- some of the bad actions that happen
14 with swap dealers, on one side, or dealers on one
15 side and a customer on the other side, and given
16 that swaps today are still pretty opaque
17 instruments, there's an informational advantage
18 that one person has over the other person in these
19 markets, and so business conduct is a crucial part
20 of Dodd-Frank because you've got a customer that
21 -- you've got basically built in information
22 asymmetry in these markets, which you have to deal

1 with, and business conduct is one of the few ways
2 of dealing. In fact, you could argue that a lot
3 of things that happened in the financial crisis
4 wouldn't have happened if you didn't have those
5 sort of built in information asymmetries in the
6 sort of this new derivatives market.

7 MR. CHERN: Yeah, and those
8 informational asymmetries that Michael is talking
9 about stem from your direct interaction with a
10 customer, so in other words, someone who's -- this
11 is not predicated strictly because you're on both
12 sides of the market providing liquidity,
13 especially if you look at, you know, the futures
14 exchanges as an example. You know, you could be
15 on both sides of a market trading with an
16 anonymous counter party, you have no idea which
17 direction that guy might be going in until the
18 trade hits your books, and you know, there's no
19 futures dealer designation right now. The futures
20 function perfectly through 2008. There's, you
21 know, daily mark-to-market, intraday
22 mark-to-market, anonymous counter parties -- it's

1 fully liquid, so the information asymmetry does
2 not exist. And so to the extent we can be
3 successful in pushing as many of these swaps to be
4 centrally traded and cleared, and margined, you
5 know, and I understand it's not going to cover
6 every use of swaps, but the vast majority of them
7 will absolutely -- can be pushed in this
8 direction. Now you've reduced information
9 asymmetries, you have really reduced so much of
10 the risk that was -- that went hand-in-hand with
11 trading these things in that more opaque manner.

12 So, I think that -- you know, one of the
13 questions I find myself pondering is, to the
14 extent, it kind of goes back to Ron's point, which
15 is, as we are in this transformational period
16 where we are trying to get everything clear to the
17 extent we can, you know, are we overstepping in
18 one place because we're trying to create these
19 definitions to solve a problem that exists today
20 when by and large maybe 90 percent of that problem
21 is going to go away and we could be focusing on
22 solving the other 10 percent in a much more

1 targeted fashion?

2 MR. FAJFAR: Can I just add -- and then
3 we'll get to Sean -- a lot of -- you've talked --
4 what do the panelists -- when do they think that a
5 large part of the market, especially for
6 commodities swaps, will be cleared? What's your
7 view of how long that is going to take? Because
8 it seems -- the idea that we should write the
9 definition for that time would be less of a
10 consideration if that was going to be further on
11 in the future.

12 MR. MASTERS: You know, I think that
13 depends on a large part of -- I mean, the CFTC has
14 proposed this idea of listed head equivalents, you
15 know, not to bring out another acronym, LIGs, or
16 listed head equivalents adjusted for delta,
17 LHEADs, which if I know, in terms of -- if the
18 customer understands what the listed head
19 equivalent is of every transaction in commodities,
20 where that can be done, then it's -- in my
21 opinion, it will be pretty quick because now one
22 knows what is the disaggregated version of that

1 swap.

2 MR. FAJFAR: So, the concern that the
3 listed cleared swaps would not match -- there's a
4 lot of concern that cleared swaps wouldn't match
5 the customers' needs and there would be -- that's
6 not as much of a concern? That we think that
7 we're going to go to getting cleared swaps that
8 match customers' needs well?

9 MR. OSTRANDER: I think it depends on
10 the markets that you're talking about. You can
11 see, you know, how they customize interest rate
12 swaps or how it's being cleared. In other markets
13 I don't think it's going to be customized enough
14 with appropriate risk management frameworks around
15 the products to be cleared quickly. It's going to
16 take some time for that to develop.

17 So, the answer will depend significantly
18 on the underlying asset class.

19 MR. FILLER: I think the answer is --
20 and it's not for discussion here, but what your
21 final rules are going to be on unclear swaps. I
22 mean, as proposed, there are some concerns that

1 they're not punitive, but make it very difficult
2 to go -- and almost encouraging cleared swaps, and
3 I'm a big clearing guy so I am not an objection on
4 it, but there's so many end users out there who
5 are seeking not to be required to post margin and
6 clear it and so forth, and I think the actual
7 answer to your question is, what would be the
8 final rules in unclear swaps adopted by the
9 commissions.

10 MR. COTA: I think relating to that,
11 there are a lot of clearing mechanisms that really
12 don't have a lot of volume because there's not --
13 the requirement isn't there yet, so, you need to
14 have the requirement and the expectation that
15 you're going to have to clear in order for those
16 markets to emerge. The NYMEX ClearPort or CME
17 ClearPort is a big example of that in energy where
18 you can get lots of delivery points for that, but
19 there's very little liquidity in a lot of them
20 because you can do it better with a swap, so that
21 will transform when you have that date and what
22 the alternative penalty is.

1 Unrelated to that, one of my questions
2 is, you know, how do you segment the industry?
3 So, for example, there are very large financial
4 players that are critical parts of the petroleum
5 infrastructure and in the ag arena there are very
6 large ag players that are very big in the
7 financial segment, so all of these -- these very
8 large entities have many different subcomponents
9 and sub corporations with different layers of
10 ownership, but the way that they operate is a
11 structure where -- whether it be through loss
12 leader activities or for different market vantage
13 points, the entire entity has an integrated way of
14 dealing with the different swap activity. So, how
15 do you segment those related activities when they
16 are intertwined into a greater project?

17 So, as an example, you know, my industry
18 I'm taking futures or swaps and converting them
19 into customer forwards and because I'm an end
20 user, I don't have to worry about all that stuff,
21 but similar things happen in other areas of the
22 chain and different -- the things that make me

1 scratch my head are, why are hedge funds currently
2 buying tank bottoms in petroleum, which is a
3 static inventory that never changes? You know,
4 why are they doing that? There's got to be some
5 reason I haven't figured out yet. Why are people
6 buying stranded gas wells? There's got to be a
7 reason for that. And if there -- if you have an
8 entity that is doing some physical portion of the
9 market, that's an important part of that market,
10 but it shouldn't exempt them in the segmenting of
11 the other areas, and I really don't know how you
12 guys are going to tackle that, but to me it's one
13 of the key aspects of implementing the rules.

14 MR. WALTON: Could I address Mr. Cook's
15 question about the behavior rules? I hate to
16 again be parochial, but in the context of the
17 hundreds or thousands of banks that might have to
18 register, the conduct rule component of the swap
19 dealer definition and the swap regulatory scheme
20 is of no issue for banks. We are substantially
21 regulated by the Federal Reserve and the OCC and
22 the behavior standards that are implied for swap

1 dealers and the record keeping requirements and
2 the rest are not substantially greater or more
3 onerous than the requirements that already exist
4 for banks under OCC or Federal Reserve regulation.

5 The real issue, again, for banks, with
6 respect to the swap dealer characterization, is
7 not those standards. It's section 716, which says
8 that if we are a swap dealer, we can't use the
9 Federal Reserve window and we don't have FDIC
10 insurance. So, I think when you think about the
11 other regulatory -- or the other statutory
12 justifications for characterization as a swap
13 dealer with respect to behavior and the rest, and
14 you focus on the element of the statute that says
15 there should be coordination with the federal
16 banking regulators in developing these
17 regulations, that the two commissions should take
18 considerable comfort from the fact that if you
19 exclude banks, and frankly most banks are going to
20 have to register anyhow in respect of interest
21 rate and currency transaction components, it's
22 this other area which -- and there's an exemption

1 with respect to the qualification for federal
2 insurance if you're just doing interest rate and
3 currency -- it's these other activities that
4 create the death penalty risk.

5 I think you should take considerable
6 comfort if you were to reach a conclusion that
7 banks should be exempted from the types of
8 behavior that we're talking about from the fact
9 that all of those conduct rules that you're
10 concerned about will continue to apply to that
11 group of exempted institutions anyhow.

12 MR. GRANT: I think then we get sort of
13 back to the question that Mark asked earlier about
14 the desire to focus on motivation but then the
15 desire for clarity and kind of the conflict, and
16 one of the proposals that has been mentioned is
17 the idea of safe harbors, but what would a safe
18 harbor be that would effect, you know, hundreds of
19 regional banks or that would provide clarity to
20 them but wouldn't just swallow the rule?

21 MR. WALTON: We've proposed a specific
22 exemption that I've got a copy of -- the rule that

1 was -- or the proposed safe harbor that was
2 included with our comment, but it would be a
3 customer-driven transaction that is permitted by
4 our primary regulator where the risk aspect
5 of that transaction is completely replaced with a
6 mirror transaction into the market so there is no
7 primary risk that is being taken by the bank in
8 respect of that transaction. It's
9 customer-driven, so it's a brokerage type
10 activity, and I think that fundamentally when you
11 talk about dealer versus broker activity, that is
12 the distinction that people have in mind when they
13 think about swap dealing. It is a customer-driven
14 transaction permitted by the primary bank
15 regulator, the risk of which is immediately laid
16 off in the market, so it's only balanced book
17 transactions by banks, not the unbalanced thing
18 that created the problems in 2007 and 2008.

19 MR. GRANT: And would that differentiate
20 between some of the larger dealers and the
21 regional or smaller dealers?

22 MR. WALTON: Offhand, I can't see that

1 there is an exception there that would relate to
2 the size of the institution, but I'm not sure that
3 there is an issue -- that it is an exemption that
4 Bank of America or JP Morgan shouldn't be allowed
5 to use either. If the net effect of the
6 transaction is beneficial, the size of the
7 institution using it shouldn't matter.

8 MR. OPPENHEIMER: The working group has
9 also put out a proposal on how to identify those
10 things that would not constitute swap dealing.
11 We've circulated it, it's sitting at everybody's
12 place at the table and I think there are some
13 extra ones over here if people want to take a look
14 at them, but it goes through sort of what we've
15 been calling a peel the onion kind of a process
16 and it says, okay, first take this activity,
17 that's not swap dealing, take it out of the
18 definition, and the first one would be hedging or
19 mitigating commercial risk associated with being a
20 producer, processor, merchandiser, or end user of
21 a commodity. Then it takes out trading, unless
22 the trading is market making, which fits in there,

1 or is a customer driven transaction.

2 And so it's not necessarily safe
3 harbors, but it goes through the same kind of a
4 process of saying, we're not entirely sure we know
5 how to define exactly what is dealing, but these
6 things are not dealing, and when you peel those
7 away you're left with a core. And to go to Mark's
8 earlier question of, you know, what kind of record
9 keeping -- you know, what's the proof -- I don't
10 think there is a record or a piece of proof and
11 we've lived with that in many ways. It's not
12 comfortable, of course, we want clarity. I think
13 the clarity is in the pieces of the onion that you
14 peel away and there may be some lack of clarity
15 left -- with respect to what's left, and then you
16 look at a totality of circumstances and there are
17 a few I'd throw out. You know, was the trader
18 transaction done by a core group of people whose
19 job it is to market financial instruments to
20 customers or was the trade done by somebody who
21 also manages a physical portfolio? Was the trade
22 done against a counterparty with whom you only

1 deal in financial instruments or was it done
2 against a counterparty with whom you trade
3 physical commodities throughout the course of the
4 day? Is the organization structured in a way that
5 the marketers are separate from the balance of the
6 firm? And then, is the book -- this may not be
7 articulated all that well -- but is the book
8 managed generally as a book or do you do swap
9 transactions on the basis of a price that you pull
10 from the futures market, add a markup to it, and
11 give to a customer, which is a standard dealer
12 kind of a structure? Those are just a few, but
13 the idea would be that at the end of the day that
14 would be a totality of the circumstances kind of a
15 test.

16 MR. FAJFAR: I'd like to go back to -- a
17 little bit -- and we have about a half an hour
18 left -- I asked the question, you know, if the
19 same end users are doing the same swap with
20 different people would have different results, and
21 I haven't really heard a lot of disagreement. And
22 it seems that -- I just want to get on the table

1 -- that the view we should take of the swap dealer
2 definition is really that it should have different
3 application to different types of people so that
4 if, say, you're, you know, a registered FCM, this
5 is sort of what a swap dealer -- you would be out
6 -- basically you're saying would be out of the
7 swap dealer definition and the reason you would
8 give is because you're taking riskless principal
9 transactions. And then if you're a commodities
10 firm, you would be out of the -- the rule that
11 would apply to you would be that because you're
12 hedging and you're connected with a commodities
13 business, that's out of the swap dealer
14 definition. You know, and then we could go around
15 the table and each person, except for Rick, would
16 give his reason why he's not covered. And that's
17 -- I think you have to recognize that to somebody
18 who's not in the business, that looks a bit odd,
19 that basically you're having different -- like you
20 said, you have this general rule then with very
21 specific carve outs. And I'd just like to
22 clarify, that's really what we're -- that's how

1 we're saying this definition should apply, because
2 the other way is people would look at -- they'd
3 say, there's four factors in the statute, they're
4 reasonably clear. I mean, there's some ambiguity.
5 And I think the starting point was if you do that,
6 you're a swap dealer, regardless of why -- what
7 your reasons are, and there's the idea there of a
8 level playing field. It seems here -- saying, no,
9 no level playing field because the standard that
10 protects him won't protect me, so I need a
11 different standard that will protect me.

12 How do you -- I'm sure that's not the
13 way you would characterize it, but --

14 MR. MASTERS: I mean, I think, you know,
15 you've got -- like I said, it's disjunctive.
16 You've got four categories and they're
17 disjunctive, so it is what it is. I mean, the
18 statute says what it says. I mean, you know,
19 policy -- you know, you can argue different ways
20 about it, but the statute is pretty clear.

21 MR. OPPENHEIMER: I strongly disagree
22 with that. You know, the third prong of this

1 statute basically says anybody who uses a swap is
2 a swap dealer. Okay? So, you can't sort of start
3 with that and say that that's a model of clarity
4 or what anybody's congressional intent was. And
5 you look to the securities laws, there is this
6 similar prong with respect to dealer and the
7 securities laws. Basically anybody who buys their
8 self a security for its own account, the
9 securities laws never intended to capture
10 everybody in that context as dealer.

11 So, the only way to look at it is to,
12 again, I said it before, marry that to Exception
13 C. When you do that, I really don't think there
14 is precise clarity that anybody could look at and
15 say, I understand where one ends and the other
16 begins, and so you have to go through the process
17 that we're going through of looking at specific
18 kinds of conduct and saying, should that be dealer
19 conduct or not.

20 Now, I don't necessarily think that you
21 have to have a rule that has each exception carved
22 out. I think the Commission can give guidance

1 outside the context of a rule. I don't think that
2 really matters but I think the notion that you can
3 look at the rule and everybody should be able to
4 decide what they are is inaccurate.

5 MR. OSTRANDER: I also -- sorry, I
6 wasn't quite thinking of the safe harbors as
7 saying somebody is a swap dealer, but we're going
8 to let them behave as a swap dealer, for whatever
9 reason we're going to let him do it. I was
10 thinking more that the safe harbors would help
11 someone understand what isn't swap dealing
12 activity. And I know that's a subtle distinction,
13 but I do think it's an important difference that
14 we're not saying here's 30 types of entities that
15 are engaged in activity that really everyone says,
16 yeah, that's swap dealer activity, but we're going
17 to let them have a pass. I think it's more, you
18 know, if you were one of these funds or you're
19 doing things, we're going to either presume or
20 give you the benefit of the doubt that you're not
21 acting as a swap dealer. Of course, you can be
22 proven differently if you really are taking

1 advantage of the rules, but it wasn't that
2 everyone's a dealer and we're going to give 30 or
3 50 or whatever people outs.

4 MR. FILLER: I mean, I think the hardest
5 or the most important part is, what is a swap
6 dealer and what is not. If you fall within the
7 definition of a swap dealer, whatever that final
8 definition is, then you have to register, you have
9 to have that capital, you've got the reporting
10 obligations, you've got the business conduct
11 activities, and so from the policy perspective,
12 what are the intent of bringing in registration,
13 capital, reporting, business conduct, who --
14 what's the intent behind Dodd- Frank and which
15 firms are really designed to meet those other
16 regulatory obligations. So, the other thing is,
17 okay, we'll make a broad definition of swap
18 dealers and then exempt everyone. Well, I don't
19 think that's the right approach.

20 I think the better approach is having
21 very specific exemptions or whether you go the
22 safe harbor approach, I mean, providing guidance

1 of which firms do not fall within the swap dealer
2 definition. And, you know, as I said earlier, we
3 know the ones that are going to be. It's just
4 whether or not any other firms out there -- those
5 around the table here and others who have
6 submitted comments, is the intent of Dodd-Frank to
7 go after those other firms as a swap dealer? They
8 may fall under another definition, they may not
9 fall within the merits of it. If I'm a swap
10 dealer, if I'm Morgan Stanley, I'm a swap dealer,
11 I've got to report all the swaps I'm doing with
12 all these end users so the commissions are going
13 to capture that information pursuant to the swap
14 dealer reporting obligations, but is it really --
15 if I'm the commercial or the bank or whatever, is
16 that really the intent of Dodd- Frank for me to do
17 the reporting, for me to have that capital, for me
18 to register? And I think not.

19 MR. PROSSER: It seems inconceivable to
20 me that we are a physical mover of commodities, we
21 own bricks and mortar in the commodity space, that
22 it was ever the intent of the law to take a firm

1 that moves tons of wheat through the system and
2 happens to use swaps to avert risk, to be caught
3 up in the definition of a dealer. This has been
4 our business practice forever.

5 MR. FAJFAR: But that's not what I'm
6 saying. I'm not saying Clause 3, you know,
7 includes everyone and then we have to back them
8 out, but it's -- there's the equal argument that
9 if you were a swap dealer, do you then pull back
10 because you're in the commodities business, and
11 how do we write the rule and apply it? Do we let
12 the commodities firm decide? Do we ask, you know,
13 ask Ron Filler since he knows who all the dealers
14 are, we ask him, is he the one that then -- it's
15 how do you write that rule that says -- I agree
16 that a commodities firm that is not a dealer is
17 not a dealer, but the question is, is a
18 commodities firm that is a dealer -- is it then
19 pulled back because it's a commodities firm?
20 That's really the issue.

21 MR. BERKOVITZ: Right, and I would just
22 add from a statutory interpretation perspective,

1 Congress knew how to exclude specifically
2 commercial and hedging activities. It's part of a
3 factor in the end user exception, it's part,
4 partially, in the major swap participant, which
5 swaps do not get included whether you're an MSP,
6 but it's not in the swap dealer definition in a
7 clear, straightforward way. We're left with prong
8 three to interpret it, so I guess I would ask the
9 question, is there no -- I'll ask Ron, under the
10 working group's language, would there be
11 potentially no commercial firms then that would be
12 swap dealers? Or are there maybe some very large
13 commercial firms that do a lot of swap dealing
14 activity that might fall within and some would
15 not?

16 MR. OPPENHEIMER: I think that's a very
17 valid and fair question and it helps respond to
18 Mark's point too, and that is, I imagine that
19 there are some. I think, you know, I hate to
20 bring up a specific firm's name, but they've put
21 themselves out there and said so, and I think, you
22 know, Cargill is an example. They're a large

1 commercial firm, they have some swap dealing
2 activity. Just because you're a large commercial
3 firm, I don't think that anybody is suggesting
4 that that is a blanket exemption. If you engage
5 in swap dealing activity somewhere within that
6 operation, then you're a swap dealer, but I think
7 the point everybody else is trying to make and
8 that I'm trying to make is that your commercial
9 activities that are not swap dealing activities
10 shouldn't bring you over the line just because
11 you're active in a particular swap market because
12 you, you know, occasionally make two-sided
13 markets. There are a number of things that
14 commercial firms do that look like facilitating
15 and accommodating, but they're really not dealing
16 activity. They're using swaps as a tool in their
17 business either for hedging or taking a position
18 in a market.

19 So, I'm not suggesting that just because
20 you have commercial operations you get exempt.
21 There are firms that have distinct swap dealing
22 activities within their firms.

1 MR. WALTON: Go ahead.

2 MR. COTA: I think the same thing is
3 true for some of the banking entities that are in
4 the commercial business. Those commercial
5 entities are very critical and in my particular
6 industry, the petroleum industry, I often cannot
7 rely on the traditional commercial players to
8 supply in a tight market, but I can always rely on
9 the banks to have the commercial product to supply
10 in that tight market. So, there's a valid reason
11 for them to be in that market that is important,
12 but it's the same point, just conversely.

13 MR. WALTON: The point I wanted to make
14 is, I think the thread of what Mr. Prosser is
15 saying, Mr. Oppenheimer is saying, and what Mr.
16 Wasson's saying, is that you have this statute
17 that's written, my sense is, to create a very
18 broad standard for what might be swap dealers and
19 the process you're going through now of listening
20 to people where there are specific commercial
21 issues that are being characterized in that way
22 was what was intended, so that the Commission

1 could go in, not in the short period of time in
2 which Congress put this act together, but had the
3 time to look at circumstances where the broad
4 definition simply doesn't fit, and I think that
5 the Congressional history here is consistent with
6 that.

7 And I think the examples that you're
8 being given are circumstances in which companies
9 use swaps incidental to a larger business
10 transaction, not the swap as the core of the
11 profit that they're trying to make. A bank
12 doesn't enter into a hedge transaction with a loan
13 customer in order to make money off of the hedge.
14 It does it because it wants its loan to be secure
15 and it wants to make the loan, and I suspect that
16 in the case of the various commercial end users,
17 they are not in the category of what I think are
18 the 20 to 25 firms people think of as swap dealers
19 whose primary motivation is to profit from the
20 swap itself. It's a swap that's entered into
21 incidental to a broader business operation and
22 derivatives are so wound into the way in which all

1 of these commercial institutions do business that
2 the risk is that if you don't create exceptions
3 for these incidental conduct, and you force people
4 out of using derivatives in a useful way, for
5 instance in lending transactions or otherwise.

6 So, I think the fundamental notion that
7 creating exceptions for particular circumstances
8 would be detrimental to treat people as swap
9 dealers and it shouldn't be done. It's just
10 wrong.

11 MR. WASSON: I would just like to say,
12 in the electric business -- and let me echo -- I
13 mean, I agree with you 100 percent because in the
14 electric business we've been using bilateral
15 contracts for 100 years and we haven't changed a
16 thing with regard to the way we were doing
17 business, but all of the sudden as a result of
18 Dodd-Frank, you know, the CFTC is perhaps
19 proposing definitions that call some of what we do
20 swaps. But we never viewed them as swaps and, you
21 know, we've been doing these things -- we've been
22 meeting the demand for electricity because we have

1 a public service obligation. If someone comes
2 into our service territory, we have to provide
3 them electricity. We don't have an option. We
4 don't have a choice. That's a public service
5 obligation every electric utility has, and we have
6 to do that. And we enter into swaps, as you may
7 define them, for purposes of, you know, protecting
8 those customers from price volatility in the
9 (inaudible) market, but it's totally incidental to
10 our core business, which is keeping the lights on.

11 MR. RADHAKRISHNAN: So, let me ask a
12 question, and I want to highlight to the panel
13 what the two commissions said in the proposed
14 rulemaking, which was -- and it's on page 80177 of
15 the Federal Register release. The Commission
16 said, "We believe that persons who enter into
17 swaps as a part of a regular business are those
18 persons whose function is to accommodate demand
19 for swaps from other parties and enter into swaps
20 in response to interest expressed by other
21 parties. Conversely, persons who do not fulfill
22 this function should not be deemed to enter into

1 swaps as part of a regular business."

2 Now, isn't what you're saying -- what
3 you are doing, you're not accommodating demand, is
4 that what you're saying?

5 MR. WASSON: We are not accommodating
6 demand for swaps, we're accommodating demand for
7 electricity.

8 MR. RADHAKRISHNAN: Okay. And that's
9 the distinction.

10 MR. WALTON: We're accommodating demand
11 for loans in circumstances where the loan, to be
12 safe, and for the customer, to be safe, needs to
13 have a hedge corresponding to the commodity that
14 we're secured on.

15 MR. RADHAKRISHNAN: I'm not saying I
16 agree with you, I'm just trying to clarify what it
17 is -- that's your point? Is that your point?

18 MR. WALTON: Mm-hmm.

19 MR. FAJFAR: So, are we done then? Then
20 we put that -- there's no real objection, we could
21 just clarify that a little bit in the rule,
22 address some of the other -- there were some

1 comments, you know, that need to be addressed.
2 Just -- there seems to be consensus is a dealer is
3 somebody who accommodates demand for swaps and
4 facilitates other people entering into swaps as
5 part of -- that's their business. So, we could
6 put that as the definition.

7 MR. WASSON: Mark, it's the third prong.
8 That's their business. They're regularly carrying
9 on a business for their own account, and an
10 electric utility that's trying to protect their
11 customers through hedging is not doing it for
12 their own account. I mean, they're not -- that's
13 not their business and a bank is not doing it for
14 their own account.

15 MR. WALTON: Yeah, I think, are you
16 done? The question would be to a bank, and again
17 I'll be parochial, that looks at the risk of being
18 characterized as a swap dealer and is out of
19 business if it is other than an interest rate or
20 FOREX and says, okay, if I'm going out and
21 pitching loans to customers right and left every
22 day and as part of that, when the customer says,

1 what do I need -- I want to borrow against my
2 wheat, what borrowing base will you give me? --
3 and the answer is, it's here if you're unhedged,
4 but it's here if you're hedged because I know that
5 the value is more dependable. They're making that
6 pitch every day and using derivatives as a
7 component of that. Have they then entered the
8 business?

9 MR. FAJFAR: But then aren't you saying
10 that -- well, let's just put out -- then for all
11 the businesses, aside from the IDI exception, we
12 have the general standard you can accommodate
13 demand, but there should be types of accommodating
14 demand and facilitating interest that are not swap
15 -- that's not really a definition of swap dealing
16 because there's types of it, for example, if
17 you're flat, if you're a riskless principal, there
18 you're accommodating demand, not a swap dealer.
19 If you're accommodating demand in conjunction --
20 again, I get back to the same -- we seem to -- we
21 had consensus on what it is and then we said,
22 well, but, no, I know I do that in my business,

1 but I do it -- it's not really or --

2 MR. OPPENHEIMER: I don't think we quite
3 had the consensus that you might have thought.
4 But, you know, if you put the words "for the
5 purpose of" that would be very helpful. If you
6 divorced it from a commercial transaction, that
7 would be very helpful. If you divorced it from an
8 occasional transaction where a counterparty with
9 whom you trade physical all day long says, in this
10 particular case, I'd prefer to do it as a swap,
11 would you do that for me -- you can take it to
12 some absurd conclusions if you think about it.

13 Somebody goes to a swap dealer for a very bespoke
14 energy swap transaction and that swap dealer
15 decomposes it and lays off all the risk that he
16 can on the futures market, let's say, and has a
17 very small bespoke risk left and goes to the
18 commercial firm it knows has a profile that can
19 actually absorb that piece of risk and goes to
20 him, would you take this risk from me? Now you're
21 going to convert that end user into a swap dealer
22 because he accommodated the swap dealer? Those

1 kinds of things need to be carved out, so I think
2 you make progress but you don't get there all the
3 way so there's not quite consensus, but that's the
4 direction I think you need to be going.

5 MR. NICHOLAS: Mark, I mean, you know,
6 you raise some good questions and I think we
7 probably would disagree on the definition of
8 dealer if we spent another couple hours on this
9 topic. But I think that one of the factors that
10 probably should be considered is, you know,
11 particularly with respect to firms whose
12 activities are kind of on the borderline is the
13 presence of other robust regulation -- excuse me,
14 the gentleman over here sort of mentioned that with
15 respect to banking regulators. I mean, I really
16 think the thrust of Dodd-Frank was to focus on the
17 unregulated entities and to the extent that you
18 have another robust set of regulations, you know,
19 I think there's less of a need to push it into the
20 swap dealer category.

21 MR. CHERN: Yeah, I want to -- and I
22 tend to agree with that and I think that if I

1 could expand on Ryan's example a little bit, which
2 I may not completely agree with, but part of your
3 example there, he was talking about, you know, a
4 very bespoke energy contract which a dealer then
5 provides, you know, accommodates the demand for
6 that swap and then lays off the risk on the
7 futures market, was part of the explanation.
8 That's me. That's a lot of entities like CTC,
9 several entities out there that are competing in a
10 fully regulated marketplace, standard, cleared,
11 transparent, you know, all that stuff that we're
12 trying to encourage. Now, if we can succeed again
13 in getting as many of these swaps as possible to
14 be transparent, centrally traded and cleared, and
15 now keep in mind that, you know, we're talking
16 about swaps and Ron used the example of some end
17 user that may need a very particular customized
18 set there, if they -- if the dealer who trades
19 with the end user then lays off the risk on the
20 futures market, I think we would all be in
21 agreement that whoever was on the other side of
22 the futures market that helped the dealer lay off

1 that risk, that trader is not a swap dealer,
2 they're trading futures.

3 Well, that's clear enough, but now if we
4 succeed in getting these swaps, that now the
5 connotation of a swap is going to be, you know,
6 some OTC bilateral negotiated contract, but now
7 we're going to get these swaps to be -- no longer
8 OTC, they're going to be clear, they're going to
9 be transparent, they're going to be, you know,
10 listed. Now, if we can get -- if we can succeed
11 there, all of a sudden now instead of the dealer
12 laying off the risk on the futures market, they
13 actually lay it off on some SEF or they lay it off
14 on some exchange where there's a swap that's
15 traded. All of a sudden the entity that they trade
16 with to lay off the risk is now a swap dealer,
17 whereas a second ago when it was laid off on a
18 futures exchange, identical in terms of the
19 transaction, that was not a swap dealer, and I
20 think that that's part of the real problem here.

21 MR. RADHAKRISHNAN: I just would like to
22 make one observation in response to comments that,

1 you know, people should not be swap dealers
2 because they are otherwise regulated, and that's
3 this. One, you know, we're constrained by the
4 statute.

5 Two, there's a school of thought that we
6 don't force you to do things, you voluntarily
7 choose to do things and if you do things that
8 attract regulation, well then, guess what, you've
9 got to register. Entities that do both futures
10 activities and securities activities have to
11 register as broker dealers and FCMs, there's just
12 no way of getting around that. And to echo a
13 point that Robert made, if you look at the scheme
14 that's being proposed, contained in the
15 statute and the Commission's proposal, one of the
16 elements of being a swap dealer is, apart from
17 registration, is you've got to meet business
18 conduct requirements, you've got to meet capital
19 requirements, you've got to meet reporting
20 requirements, and you've got to meet margin
21 requirements.

22 So, John said, well, why make me -- I

1 think you had sent me the letter saying, you know,
2 why -- I'm an FCM, why make me be a swap dealer?
3 Well, an FCM is not subject to the business
4 conduct requirements. You're only subject to the
5 business conduct requirements as an example if you
6 are a swap dealer. You're only subject to the
7 margin requirements for uncleared swaps if you're
8 a swap dealer. So, I think -- I don't want -- I
9 want to make sure people don't lose that point
10 which is, you know, Congress created a scheme for
11 us and we've got to be faithful to that scheme
12 that Congress created.

13 MR. FILLER: Ananda, just to carry out
14 your -- I agree with you, but when you look at the
15 traditional FCM-BD definitions, it's a solicitation
16 type perspective and maybe in looking at these
17 four tests, adding a primarily, holding yourself
18 out, you know, some kind of more than, you know,
19 the majority of your business type stuff, a
20 primary type test might be a good way to provide
21 relief for the people who are looking for it and
22 still bring in your traditional swap dealers.

1 I also want to add two other things that
2 had not been discussed that needs to be addressed,
3 and they were in the comment letters but I still
4 think it's important, and whether the other
5 panelists want to comment on it, a lot of firms do
6 a lot of what we call internal or back-to-back
7 swaps, and if -- I'm sorry, Rick, if I use Morgan
8 Stanley does it with another Morgan Stanley
9 entity, and Morgan Stanley, the primary firm
10 registers as a swap dealer and doing an internal
11 or a back-to-back with another Morgan Stanley
12 affiliate, is the intent also to bring in the
13 affiliate into the swap dealer definition?

14 So, I know there's been a lot of
15 comments --

16 MR. FAJFAR: Let's get that --

17 MR. FILLER: I'm sorry?

18 MR. FAJFAR: Let's get that on the next
19 panel.

20 MR. FILLER: Oh, okay.

21 MR. WALTON: Could I comment on that
22 one? Because it was about regulation I just want

1 to respond. I certainly understand that a bank
2 can stop offering hedges as part of loans. It
3 will mean that we offer fewer loans and take fewer
4 loans because the loans would be more risky and we
5 have lots of pressures on banks from lots of
6 sources saying that we should make more loans
7 because they are beneficial to the economy. So, a
8 structure that says, well, just make fewer loans,
9 has other implications associated with it, and
10 second of all, it is inconsistent with a scheme
11 that is designed to allow commercial end users not
12 to have to post margin to ignore the fact that for
13 all the small players in the agricultural and
14 energy area that don't have an external
15 relationship, if you bifurcate that relationship
16 by saying that the bank can't also take the swap
17 or else the bank's out of business, that person's
18 going to have to borrow to post margin because its
19 only relationship with the swap dealer is the
20 derivative relationship.

21 So, I think it's inconsistent with the
22 other positions that the Commission has taken with

1 respect to posting margin for commercial end users
2 and the elements of the statute to create an
3 exception for that should just ignore those
4 elements and say, well, banks ought to be
5 characterized as swap dealers when they're
6 engaging in riskless principal transactions.

7 MR. MASTERS: I'm just trying to
8 understand. I mean, why would you just, you know,
9 given your predicament, why wouldn't you just use
10 the futures markets? Because if you buy a swap
11 from somebody else to hedge, you know, your
12 customer, then they're just going to the futures
13 markets and doing the hedge if it's similar to
14 what you describe and why not use it just in the
15 listed futures markets and not worry about it?

16 MR. WALTON: Most of our customers are
17 people who if we say, go to New York and Chicago
18 and trade derivatives there, will tell us that
19 they will not do it, and weren't those the folks
20 that created the financial meltdown in the first
21 place. They want to deal with their local banker.

22 MR. MASTERS: I understand. I'm saying,

1 why don't you do that?

2 MR. WALTON: We lay off every trade that
3 we take with the customer immediately. We create
4 a balanced book and we take the trade from the
5 customer and immediately mirror that trade in the
6 market. That's what virtually every bank that
7 engages in this activity does.

8 MR. MASTERS: Right. I understand that,
9 but I mean where you do that, you could do that in
10 the futures markets as well as the swaps markets.
11 In other words, it doesn't have to be exclusive to
12 the swaps markets.

13 MR. WALTON: No, not to accommodate our
14 customers' demand, not -- I know we're not
15 supposed to get into the product definition, but
16 the way that we have to engage in activity to
17 accommodate our customer demand, that's not an
18 answer for us.

19 MR. MASTERS: But you're going to go to
20 a swap dealer who's going to do the same thing, I
21 mean, he's going to go and disaggregate it for
22 you?

1 MR. WALTON: Yes.

2 MR. MASTERS: But I mean, then they're
3 going -- that's going to get back to the futures
4 markets. So, I'm just -- see what I'm saying?

5 MR. OSTRANDER: I know we don't want to
6 get too distracted on this but I also think 716
7 would allow you to set up a separate entity
8 outside of the bank chain to register --

9 MR. WALTON: Well, it's certainly the
10 case -- I think that the -- if you said the answer
11 is that you could create a subsidiary of the bank
12 holding company, that is certainly an option for
13 the five or six largest bank holding companies,
14 but banks have substantially greater access to
15 liquidity -- I'll give you an example. My bank
16 has \$24 billion of assets. Our market
17 capitalization of the bank holding company is
18 about \$3 billion. The bank is investment grade,
19 the bank holding company is not.

20 When we are posting margin to the market
21 on the corresponding side of the trade for our
22 customer, that involves substantial bank

1 liquidity. That's not available for a subsidiary
2 of the bank holding company except for the four or
3 five largest bank holding companies. For them
4 having the transaction with an affiliate, the
5 subsidiary of the bank holding company, and then
6 they can say, we don't have to take margin on the
7 loan because we've got the mark- to-market benefit
8 through our sister company works, but it only
9 works for those bank holding companies that are so
10 large that they have access to liquidity at a
11 cost. It's, I think -- frankly, if it goes that
12 way, it's great for the big banks because it will
13 push all of that business that's in the small to
14 medium sized banks right into the hands of the big
15 banks and I know that because the larger banks are
16 marketing to our customers just that right now,
17 that when this comes, their subsidiaries will be
18 there to take those trades with an integrated loan
19 and the medium sized guys won't be able to.

20 MR. OSTRANDER: Just to make sure I
21 fully understand, I think that you're saying that
22 you wouldn't have the capital to fully capitalize

1 the swap dealers, is that what --

2 MR. WALTON: The cost for capital if we
3 are to capitalize the swap dealer and take the
4 capital requirements to do the mirror side of the
5 trade for the customer that's placed in the bank
6 is far too expensive for small and medium sized
7 bank holding companies. Yes.

8 MR. OSTRANDER: So, I guess it's a
9 ramification of the capital rules that drive you
10 -- or what they might be that would drive that
11 problem.

12 MR. WALTON: Well, no, it's not the
13 capital rules, it's the capital requirements of
14 our counterparty. It doesn't have anything to do
15 with the new capital rules, it's what the market
16 would require today.

17 MR. PROSSER: I would like to comment on
18 Mr. Walton's -- if the final solution of this
19 catches those commercial supply chain commodity
20 firms in the swap dealer definition, we will
21 change our commercial practices. We will quit
22 offering services that makes us a swap dealer and

1 retrench. Those left, medium and small producers
2 that we leave behind, that we won't provide
3 hedging services for, will go back to what's left
4 of the swap dealers which will have less
5 liquidity, less providers, therefore bigger bid
6 ask spreads, and I think leaves them in a much
7 different situation than they are today.

8 If the intent of this process is to
9 change our business practice, that would do it. I
10 hope that's not the case, because I do think that
11 we provide a service. We will not provide those
12 same services if in fact it throws us over the
13 edge. So, to the extent that these rules either
14 catch or don't catch you in this dealer
15 definition, it will change the way that business
16 is conducted and push that activity into a much
17 more concentrated space, I think, which I don't
18 think necessarily is to the public good.

19 MR. FAJFAR: We're going to get into
20 that in the de minimis test, and I know Josh had
21 some questions, so since we're at the end of the
22 first panel.

1 MR. KANS: Sure. Thank you, Mark. You
2 know, a lot of the concerns here have been
3 seemingly specific to commodities and related
4 products. I wanted to toss out for the panel the
5 same issues in the context of securities- based
6 swaps and being a securities-based swap dealer.
7 Do you have the same concerns or would the
8 industry generally have the same concerns about
9 the securities-based swap dealer causing
10 retrenchment or people offering fewer services?
11 And also I'm hoping for some comment about the
12 traditional dealer-trader distinction from the
13 traditional security space and whether or not the
14 issues that you discuss here may be different in
15 the context of the securities-based swap dealer
16 definition and maybe we can just rely on the
17 traditional distinction without all these problems
18 you're seeing.

19 MR. CHERN: I certainly have the same
20 concerns on the security side. I know that a lot
21 of the folks up here only participate on the
22 commodities side. When you look at the concerns I

1 raised earlier in terms of, you know, the
2 transparently traded, centrally traded, cleared,
3 you know, these sorts of transactions, there's a
4 large part of the market that -- you know, Chicago
5 Trading Company, we trade options on all the
6 listed exchanges and we provide liquidity and we
7 have a large book of options that we manage. It's
8 strictly internal capital, we trade our own money,
9 take our own risk, use our own models, and we're
10 providing liquidity in the marketplace.

11 So, you know, to the extent that we are
12 not participating in any of the over-the-counter
13 transactions right now, you know, those
14 transactions probably have a smaller pool of
15 competitors and we're seeing the runoff as the
16 dealers who are trading in that marketplace are
17 then laying off their risk on the floors or on the
18 electronic marketplaces for the listed exchanges.

19 To me it seems very clear. I think the
20 dealer- trader distinction is -- I'm glad you
21 brought it up. I think that that's an effective
22 distinction. Again, we trade -- we are a

1 broker-dealer registered with the SEC. We don't
2 have any interaction directly with customers, we
3 don't touch customer funds. So, from my
4 perspective we are really providing that function
5 in the markets of competing to provide an
6 efficient marketplace and providing liquidity and
7 taking the risk on our books that other people
8 don't want on their books. I think that's what

9 we're really -- you know, Dodd-Frank is really
10 intended to encourage is less centralized -- less
11 risk that's focused in just a few counterparties
12 and more transparent trading.

13 And so to the extent that we are
14 applying, you know, these definitions more
15 broadly, I think that that is going to serve to
16 diminish the number of participants and I think
17 the real impact of that is going to be, you know,
18 just as the fellow from -- Ed was saying -- he may
19 leave the market, there may be parts of the market
20 that entities could enter if they are now traded
21 in a more standardized fashion. Those entities
22 may not do that if the barriers to entry are so

1 significant that it's not commercially reasonable
2 to do so.

3 You know, in our firm, if we want to go
4 into a new market or new asset class and we think
5 we have a reason to believe we might be able to
6 provide liquidity competitively in that space, the
7 barriers are relatively low for us to enter that
8 market and I think that's a good thing. We can go
9 enter a new market on a new exchange fairly
10 seamlessly, and we can do so and dip our toe in
11 the water. If the ante to get into some of these
12 markets that we're trying to create here, really
13 trying to push some of these swaps onto listed
14 standardized venues, if we're going to try to do
15 that and we're going to try to increase the
16 diversity of liquidity providers by artificially
17 increasing the barriers to entry, we're going to
18 directly, on the margins, absolutely reduce the
19 number of liquidity providers in those places.

20 MR. WASSON: And that might have the
21 perverse effect of enhancing or increasing
22 systemic risk if we just end up with a few large

1 folks that for people in the commodities space
2 that's the only people you can deal with.

3 MR. OPPENHEIMER: Can I make one more
4 point on the -- it's not on securities-based
5 swaps, I apologize, but on the notion of barriers
6 to entry. It's a concern that I'm not sure was
7 raised as much in the comment letters so I want to
8 make it here. With respect to market making, to
9 the extent one actually engaged in market making
10 in a very narrow scope of swaps, for example, in
11 the power markets where there are multiple pricing
12 points called delivery locations, if one were to
13 provide real market making in that, the
14 consequences sort of ripple out from that. You'd
15 be maybe a swap dealer in power, you may be a swap
16 dealer in the whole other commodities sector, and
17 so as a result, the cost of that little bit of
18 market making activity in one location could bring
19 on this huge consequence with amazing costs. So,
20 the result would be similar to what people are
21 describing. You wouldn't engage in that market
22 making activity, as a result, there wouldn't be a

1 liquidity provider there.

2 The same is true with respect to sort of
3 innovation and new products that might come up,
4 because if you want to foster the development of a
5 new product, you might engage in quite a bit of
6 trading at the outset if that consequence is
7 you're a market maker for that narrow product, and
8 then you ripple out from there and bring all the
9 costs, people are going to refrain from that
10 behavior.

11 MR. FAJFAR: Could I ask -- we're going
12 to cover this in the de minimis, but especially
13 for the people who aren't on the second panel, it
14 seems that the consensus is -- to flip it around,
15 is that we should use the de minimis exception or
16 the dealer definition in order to decrease
17 concentration and increase the sources of
18 different swaps. And it seems that the reason we
19 should do that is because if we regulated those
20 sources of swaps, the expense of being regulated
21 would discourage that activity and then the
22 argument is, well, since these sources of swaps

1 didn't cause the last crisis, it's okay to leave
2 them unregulated because they won't cause the next
3 crisis.

4 So, what do we do if we find out -- we
5 write these, we allow this unregistered swap
6 activity to occur, whether it's dealing or not,
7 but then if that activity -- because the swap
8 dealers are burdened by this burdensome regulation
9 that other activity percolates along, what are we
10 going to do if then that's the cause of the next
11 crisis, because obviously the cause of the next
12 crisis will be different than the cause of the
13 last crisis.

14 MR. WASSON: Mark, I was just going to
15 say, I think it's an illusion in some respects to
16 say that we're not regulated, because I mean,
17 electric cooperatives are regulated by their
18 boards. Their self interest is they want to
19 provide electric power to their members at the
20 lowest possible cost. And --

21 MR. FAJFAR: AIG was regulated by the
22 New York Insurance Department and the OTS. That was --

1 MR. WASSON: But there's a big
2 difference --

3 MR. FAJFAR: That was their argument,
4 that we were regulated -- you can say, well, it's
5 the fault of the OTS and that's too bad, but --
6 most firms are regulated.

7 MR. WASSON: But then you could say that
8 about everyone.

9 MR. FAJFAR: But what I'm saying is that
10 the argument that I'm already regulated is not
11 really an argument to say I shouldn't be regulated
12 as a swap dealer.

13 MR. NICHOLAS: Well, I think, Mark, one
14 consideration I think that we haven't really
15 focused on is resources on the side of the CFTC
16 and the SEC. I mean, in the best of all possible
17 worlds it would be great to regulate anybody who
18 even comes close to the definition of swaps
19 dealer. You know, err on the side of caution, but
20 those type of resources are not available and I
21 think it has -- there has to be some type of
22 triage analysis.

1 I think the regulators need to focus on
2 core dealer activities creating the greatest risk
3 that were clearly the intent of Dodd-Frank to
4 focus on and the way to do that, I think, is to
5 narrow the definition somewhat, right, because
6 then you don't have entities that are on the
7 borderline that are going to require your
8 investigative and examination teams to go in and
9 look at areas that may not be creating risk.

10 So, I think resources is important.

11 MR. OPPENHEIMER: It was said before but
12 it bears repeating -- I'm sorry, Rick -- every one
13 of these swaps will be reported to a swap data
14 repository, they'll all be the subject of price
15 reporting, position limits will apply as positions
16 roll up to the reference futures contracts, so the
17 CFTC will have great transparency into this, the
18 public will have transparency into this and, you
19 know, to tie it back to what I said at the outset,
20 you start and you put something in place today
21 that gets you the biggest bang for the buck and
22 then when you really understand the true

1 dimensions of the market, if there was something
2 that was missed, you'll have the opportunity to
3 address that.

4 MR. OSTRANDER: Yeah, and I think
5 there's a couple points that I wanted to quickly
6 make. One was that, yeah, you will have access to
7 all the swaps so I think starting out slowly to
8 say who you think should be captured or even
9 enforcing or interpreting the rules slowly, you
10 will be able to see over time where the activity
11 is and decide if you think there are players who
12 are acting in a way that you feel is a dealer
13 capacity, you will have that ability.

14 And I do agree, Mark, that we can't take
15 too much comfort from an entity being rated,
16 that's a highly regulated entity already. It is
17 true that the swaps activities were not
18 necessarily -- even in OCC regulated banks the
19 swaps activities weren't regulated in the same way
20 that they would be under Dodd-Frank, but I wanted
21 to go back to your question, Josh, briefly if I
22 could, because I think it is worth pointing out

1 from our perspective a lot of the concepts that
2 exist in the securities markets and the cash
3 markets about who was a trader, who was a dealer,
4 are very applicable, easily transferrable over to
5 the swaps markets. I do not think you should have
6 to start over with these concepts while the
7 underlying products are different and I do take
8 some of the points in the releases that, you know,
9 these are not exactly equivalent. We do think the
10 concepts of being willing to enter into trends at
11 both sides of the market, being willing to provide
12 liquidity, taking risk, those are equally
13 applicable on both a cash or a derivative market.

14 MR. KANS: Meaning that the
15 dealer-trader distinction, you think on the
16 securities side, is a useful dividing line to
17 preserve in our definition?

18 MR. OSTRANDER: I think it absolutely is
19 a great place to start and you can expand those
20 concepts out to swap dealers as you could cash
21 dealers, cash traders.

22 MR. FILLER: I concur. I mean, the

1 securities industry has much more of the dealer --
2 historically the dealer role and the trader role
3 has always been for your proprietary trading or
4 for your own capital or own account distinction,
5 versus the dealer who's always dealt with a
6 principal-based type activity with some other non-
7 affiliate, meaning a client or something, using
8 your inventory or whatever, so I agree. I think
9 the securities aspects of dealer and trader is
10 right on point.

11 MR. COTA: I think that the systemic
12 risk issues are dealt with either through the
13 uncleared capital requirements or, you know, with
14 the clearing in something that is cleared, but the
15 last crisis probably won't be the next crisis and
16 the thing that concerns me is because the back
17 ends of a lot of these transactions are
18 interconnected. You know, Treasury, and you
19 should complain to Treasury's intent to exempt
20 FOREX, which is highly leveraged futures to a
21 large extent, may be something that by exempting
22 it from the clearing requirements or anything that

1 relates to Dodd-Frank, may effect the rest of
2 these markets in how they function. You could
3 also complain to Treasury.

4 MR. CHERN: I'd like to get back to
5 Mark's question for a moment. You raise the
6 question of, look, you know, if we're just focused
7 on these products here, because that's what caused
8 the last crisis, and kind of ignore these ones, I
9 think if we are focusing on the symptom rather
10 than the real problem, we would run that risk.
11 So, if we said, well, really, this problem is
12 really based on, you know, some mortgage backed
13 securities, so we're just going to regulate those
14 things now, or -- I think we'd run that risk.

15 I agree that it's not about, oh, all
16 these entities are regulated and, therefore, there
17 shouldn't be any problem. I think the issue is
18 that there were plenty of entities, or at least a
19 handful or a few handfals, that were fully
20 regulated but that the regulators didn't have full
21 view over what was going on in those entities,
22 what the activities were, and I think it's about

1 the activities, it's not about the entities. And
2 so I think that it really gets back to the
3 definition of what is a swap and if all these
4 swaps were traded transparently on an exchange
5 somewhere or on a SEF and if they were all cleared
6 and centrally traded, the regulators would have
7 had full view over what was going on and I do
8 believe that either the crisis would have been
9 avoided or would have been a fraction of what it
10 was.

11 So, I think that that is, you know,
12 central to avoiding a problem like this in the
13 future. It's not about looking at, well, where
14 did this happen, let's go solve that one sort of
15 symptom, if you will. It's the larger problem and
16 so that gets back to really, I think, my sort of
17 core concern is that we are really creating the
18 healthiest marketplace where we're fostering
19 competition, transparency, and liquidity.

20 MR. WALTON: Could I comment? The point
21 the gentleman from Morgan Stanley made about you
22 don't want to just create an exception if you're

1 regulated by the OCC. Certainly that's not what
2 we are proposing, what other banks are proposing.
3 We are proposing an exception for those
4 circumstances where the only risk you're taking on
5 a derivatives trade is credit risk of your
6 customer and taking credit risk of a bank customer
7 is the core risk that banks are organized to take
8 and are regulated in respect of that by the OCC.
9 We're not saying that because you're a bank you
10 ought to go out and trade anything. It's only
11 those trades that have a balanced book where the
12 only risk you're taking is the credit risk of your
13 customer. And we think that's appropriate.

14 MR. BERKOVITZ: Let me just -- as we're
15 wrapping up here, I just want to clarify, and many
16 of the points are excellent points and valid
17 considerations. Ultimately, though, what we're
18 engaged in here is not through the definition of
19 swap dealer to prevent the next crisis, but an
20 exercise of statutory interpretation. What did
21 Congress intend? And obviously some of these --
22 well, Congress couldn't have intended that because

1 this would be counter to this other Congressional
2 intent -- those are, you know, all considerations
3 that are valid comments, but ultimately this is a
4 very difficult challenging question of statutory
5 interpretation and rulemaking to implement the
6 Congressional intent that we're exercising.

7 MR. FAJFAR: It's 11:00, 11:01, so we'll
8 take a 15-minute break.

9 (Recess)

10 MR. FAJFAR: Okay, we're going to go
11 ahead and get started with the second panel. I
12 was asked -- some of you might have noticed we had
13 some feedback issues during the first panel, that
14 comes from people having two microphones on at the
15 same time, they're way too sensitive, so please
16 try to watch out for that.

17 We have two new panelists at this end of
18 the table, Andrei Kirilenko, Chief Economist from
19 the CFTC, and Gregg Berman from the SEC. And what
20 we're doing to do, the new panelists can just
21 introduce themselves like we did in the first
22 panel, and then we're going to go right into the

1 issues again.

2 Obviously, we had a lot of discussion of
3 the dealer -- definition of a dealer, we want to
4 get some new perspectives. We're going to talk
5 about the perspective of some counterparties to
6 dealers, whether you call them end users or
7 customers or what term you use, get that
8 perspective. We'll also talk about the affiliate
9 point that Ron Filler mentioned, and then we'll go
10 on to the other points on the agenda. So, Bella,
11 do you want to start with the introductions?

12 MS. SANEVICH: I'm Bella Sanevich, I'm
13 the General Counsel for NISA Investment Advisors.

14 MR. JANNEY: John Janney with Chelan
15 County Public Utility District, and also here for
16 the Large Public Power Council.

17 MR. MASTERS: Mike Masters, Better
18 Markets.

19 MR. CAWLEY: James Cawley from Javelin
20 Capital Markets, also here on behalf of the Swaps
21 and Derivatives Market Association.

22 MR. HIXSON: Jon Hixson with Cargill.

1 MR. TODD: Greg Todd with Bank of
2 America.

3 MR. MCCARTHY: I'm John McCarthy,
4 General Counsel at GETCO.

5 MR. FILLER: Ron Filler, New York Law
6 School.

7 MS. BOULTWOOD: Brenda Boulwood, I'm
8 the Chief Risk Officer of Constellation Energy.

9 MS. COLLIER: Mary-Margaret Collier, I'm
10 the Director of State and Local Finance for the
11 State of Tennessee.

12 MS. RUDGE: Camille Rudge, the
13 PrivateBank and Trust Company.

14 MR. KANS: Okay, thank you for all being
15 here, especially the new panelists. I'd like to
16 tee this off from a -- with a different
17 perspective from the last panel. On this panel,
18 we have people who meet the definition of I think
19 a customer of a swap or a securities based swap,
20 and also I'd like to talk a little bit and get
21 some feedback on how the regulations applicable to
22 dealers will impact customers, both good, in terms

1 of customer protection, and potentially bad, in
2 terms of -- so we hear reducing developability of
3 swaps or security-based swaps to customers.

4 So I'm hoping that the panelists can
5 spend a few minutes talking about those issues as
6 to what this all means to customers and what
7 happens to customers in the absence of regulation.

8 MS. SANEVICH: Certainly from the
9 special entity perspective, particularly as it
10 relates to pension plans, which is who our clients
11 are, both public and private, the business
12 conduct rules, which I know were meant to protect
13 customers, particularly pension plans, the current
14 state of the rules could effectively prevent
15 pension plans from using an invaluable hedging tool
16 to hedge the liabilities and to invest in the
17 assets that they feel are in the best interest of
18 protecting their plan participants.

19 I can certainly elaborate, but I know
20 many around here really have heard these issues
21 before, but in this forum, I thought it would be
22 important to raise the protections, while they are

1 very well meaning, could have serious unintended,
2 negative consequences, at least from the pension
3 plan's perspective.

4 MS. COLLIER: Yes, I'm representing
5 special entities, as well. I'm representing the
6 80,000 municipal governments in our country. They
7 include school districts, states, cities,
8 counties, and many other authorities. Last year,
9 over 8,000 of those entities borrowed money in the
10 capital markets, some of them entered into swaps.
11 There were 8,000 unique entities, meaning
12 different bodies that entered into the debt market
13 in some form or another.

14 Now, many of them didn't enter into swap
15 transactions, but that's the population that we're
16 dealing with. There were over 13,000 separate
17 transactions that involved municipal utilities, I
18 mean municipal securities, and cities, counties,
19 school districts, and so forth in this country last
20 year alone.

21 So compared to some of you who are major
22 market participants, we're very small in terms of

1 what we do in this particular market, but for us,
2 it is major; for us, the swap advisory rules are
3 major. I agree with Ms. Sanevich, for our public
4 pension funds, these rules are very difficult and
5 may prevent some public pension funds from
6 entering into these types of products.

7 MR. CAWLEY: Let me say something. So
8 notwithstanding the comments, you know, just
9 mentioned, I think if you're asking what are the
10 broader benefits of regulation for the customer, I
11 think specifically you're looking at -- while
12 there might be certain issues pursuant to certain,
13 you know, specific customers, I think broadly
14 speaking, one has to consider the broader benefits
15 of the marketplace.

16 So if you're talking about moving swaps
17 into regulated environments, I think that is
18 essentially good in contrast to what we have now
19 presently and what we've had since the inception
20 of the OTC swap markets in the '80's and '90's.

21 Specifically, when it comes to
22 execution, what you're talking about is moving

1 products onto exchanges or swap execution
2 facilities, which brings about greater
3 transparency, lower transaction costs, and
4 essentially a fair marketplace where one is
5 assured a fair shake every time they come in to do
6 a trade. So these are all benefits that all
7 customers enjoy pretty quickly in the marketplace.

8 MR. JANNEY: I wanted to just maybe try
9 to differentiate a little bit, too, instead of a
10 broad brush for the special entities, you know,
11 Mary-Margaret was talking about some of the small
12 cities and counties and others who may need to
13 hedge interest rate risk into the market using
14 swaps and other derivatives.

15 Speaking for my own utility, we're a
16 municipal corporation under Washington State law.
17 We actually have a statute that requires us to use
18 a swap advisor when we enter an interest rate
19 swap. That was something that was passed years
20 ago when we were first authorized to do that.

21 The interest rate market is different
22 from our fundamental core business, which is

1 serving our customers with electricity. We might
2 do a bond transaction and enter into a swap at
3 most once a year, probably once every several
4 years, so very infrequent.

5 We don't have the expertise on hand
6 always, and I think maybe the swap advisor in that
7 context makes some sense. However, in our core
8 business, which is serving our county residents
9 with cheap, reliable electricity, we need the
10 ability to -- we enter into transactions on a much
11 more frequent basis. The market changes
12 constantly, and sometimes we might be hedging to
13 buy, sometimes we might be hedging to sell, and so
14 it's somewhat impractical to take the same vein as
15 far as having an independent swap advisor in that
16 context, where we have the internal expertise to
17 be able to do that.

18 And our concern with the special entity
19 rules is that, if too onerous, it's going to drive
20 people out of the marketplace. Then we will have
21 fewer counterparties to transact with, the big
22 spreads are going to widen and it's going to

1 become much more costly for us to transact.

2 In addition, instead of being able to
3 transact with 10 or 12 different counterparties,
4 if I'm now down to 3 or 4 because that's all
5 that's left transacting in the market, then my
6 concentration risk and my credit risk with those
7 counterparties goes up correspondingly.

8 So I think that consideration should be,
9 if we're going to look at the special entity
10 definition in that context, customer protection,
11 not having a broad brush, that everyone falls into
12 the same bucket in that category.

13 MR. KANS: And just to follow up in the
14 context, specifically of the dealer definition and
15 the scope of the dealer definition, is there
16 reason to be concerned then generally that having
17 too broad of a dealer definition is going to
18 unduly limit the ability of customers to obtain
19 the services they need, or is the issue more in
20 terms of something that's not on the table for
21 this panel, which are the actual business conduct
22 rules applicable to dealers?

1 MR. JANNEY: Just a comment on that, we
2 transact currently with a wide variety of
3 counterparties. Some of them are large banks
4 which I think would probably clearly fall under
5 the dealer definition. We also transact with each
6 other. We may have offsetting exposures that it
7 makes sense just to transact between two different
8 utilities. And there are also energy companies
9 that are in the marketplace.

10 If the dealer definition gets too broad
11 and it starts chipping away at some of those
12 non-bank counterparties that we currently transact
13 with, again, we get that concentration event,
14 which is going to drive competition out, increase
15 our spreads, and increase our overall costs.

16 MS. SANEVICH: Certainly from our
17 perspective, the counterparties we deal with are
18 the entities who will register as dealers, there's
19 no question, they will be dealers. The big banks,
20 you know them when you see them, you know, Ron's
21 definition, and so from our perspective, we're not
22 concerned that too many people will be caught in

1 the net and we won't have our usual providers. We
2 are concerned about the business conduct rules,
3 which are the other issue.

4 MS. BOULTWOOD: I'd say it is the broad
5 definition of swap dealer that is most concerning.
6 Just in terms of the ability of entities who
7 traditionally have created liquidity in markets
8 that are non-financial in nature, and we think
9 specifically of commodities, other non-financial
10 products, some market making occurs from the
11 broker-dealer through the swap dealer, but a lot
12 of that market making is from commercial firms
13 that have assets or obligations to supply in that
14 market.

15 And if a broad definition is applied,
16 all the infrastructure record keeping and
17 oversight requirements that go with that, you will
18 see, and I think the first panel already echoed
19 this concern, just many unable to fulfill those
20 requirements and pull back from those businesses
21 and create even less liquidity, less transparency
22 in the market, wider bid offer spreads, less

1 ability to see price discovery. And ultimately,
2 the end consumer in the United States would see
3 higher prices and perhaps an inability to get
4 transactions completed.

5 MR. BERMAN: Could I ask a quick
6 question just to follow up on that? So if we take
7 the business conduct requirements off the table
8 since it's not part of this panel, just look at
9 the breadth of the dealer definition. If we live
10 in a world -- so two years from now it's all
11 settled, everything is implemented, there's a
12 counterparty that is a dealer and there's a
13 counterparty that's not a dealer, how are you --
14 putting your fiduciary hat on -- how do you make
15 the determination that I will go with the non-
16 dealer versus the dealer even though I may be
17 afforded less protection by the non-dealer? I mean
18 would you just strictly look at prices? How does
19 this play itself out regardless of what the
20 ultimate breadth of the definition is?

21 MS. BOULTWOOD: I think when we're
22 managing our customer exposures, we're looking for

1 diversification. So you want to have the option
2 of dealing with the swap dealer if they make the
3 best markets and offer you the best prices, but
4 you also want the opportunity to transact with
5 firms that may have the commercial interests, and
6 sometimes it's those commercial interests that
7 allow them to have better pricing because of
8 better insights into the physical aspects of that
9 market. So you really need the diversification,
10 and really, in a world where you have to choose
11 one or the other, I think that's what we'd like to
12 avoid, you know, being the result of the
13 regulatory changes that are happening now.

14 MR. FAJFAR: Did you have any? Because
15 from a perspective of somebody with sort of a
16 duty, not necessarily fiduciary, how would you
17 make the choice between somebody who's registered
18 as a dealer and not registered?

19 MR. JANNEY: I think we'd continue to do
20 what we do today, which is, we look at each of our
21 prospective counterparties and do a thorough
22 credit analysis on them, look at their

1 capitalization, look at their underlying position,
2 the type of business they're in, and evaluate how
3 much exposure we have there from a potential
4 credit standpoint, and we assign a limit based on
5 that analysis that we update at least annually,
6 and we make a determination then based on the
7 credit worthiness of the counterparty, and then
8 look at the prices that we're being offered for a
9 particular transaction and select those within the
10 approved credit limits that we have for each of
11 the counterparties we deal with.

12 MR. FAJFAR: So you're not thinking that
13 process will change once -- the dealer
14 registration is basically -- won't be relevant to
15 you?

16 MR. JANNEY: The process we undertake
17 will probably not change. Our concern is that if
18 the dealer definition is too broad, there will be
19 fewer counterparties with which to have in our
20 portfolio. And again, the less competition there
21 is, the more costly it's going to be for us to
22 transact.

1 And the other kicker there is, if I've
2 got ten counterparties now and they've each got a
3 \$1 million credit limit, I can trade with each of
4 them up to the million dollar credit limit. If
5 I've only got one counterparty with a million
6 dollar credit limit, then I'm really limited
7 there, and I have to do other things in order to
8 try to manage that exposure, which, again, could
9 be more costly.

10 MR. FAJFAR: I'm not arguing with you,
11 but I'm seeing a different thing. You don't see
12 any benefit? There's no benefit going to -- the
13 fact that the person is registered as a dealer or
14 not is really not going to bring any customer
15 protection benefit or other benefit to you?

16 MR. JANNEY: I think that's true.

17 MS. SANEVICH: I'm sorry --

18 MR. CAWLEY: Could I just ask a quick
19 question? Are you talking about cleared swaps or
20 uncleared swaps?

21 MR. FAJFAR: Both.

22 MR. CAWLEY: Okay. Well, I'm a little

1 bit confused, because if you're talking about
2 cleared swaps, and if you're talking about swaps
3 that perhaps trade on SEF's, how do you even know
4 who your counterparty is?

5 MR. FAJFAR: Well, I'm asking, from a
6 customer's perspective, first of all, we very
7 strongly heard from the end users, to an extreme
8 extent they don't want to clear, so they're not
9 really interested in clearing. So when this
10 person who then does the end user swap and is --
11 the question is, do you see any benefit from doing
12 the swap with a registered swap dealer or not?
13 Yeah, if you did -- if you just went to clearing,
14 I see why -- if you went to a clearing, you
15 executed on an SEF, it wouldn't be a relevant
16 question. So really we're talking about people
17 who are doing uncleared swaps, you're right.

18 MS. SANEVICH: So I mean even though
19 this probably won't be an issue for us, but as a
20 fiduciary, which we are, and for very many, you
21 know, particularly for ERISA and for our clients,
22 I mean, you would see what the ultimate

1 requirements are for a dealer that is registered.
2 So if it gives you an additional cause of action
3 if they are required to give you a confirm
4 quickly, but normally you could not negotiate that
5 on your own.

6 Or if -- take business conduct. We
7 won't get into the substance, but let's say you
8 feel like you need those protections, that would
9 give you that protection, but if you're an entity
10 that doesn't need those protections because you
11 can either negotiate them or you know what you're
12 doing, then you wouldn't view that as a valuable
13 factor.

14 So it really depends on -- in your
15 fiduciary capacity you evaluate everything. Just
16 like in Best Ex, you can look at not just price,
17 but how responsive they are, what to do about
18 errors, whatever it is that is important to you in
19 a particular trade, you would evaluate that in
20 totality. But the mere stamp of registration
21 doesn't do much, it's really what does the
22 registration do for you and can you get that on

1 your own. And in some cases, if the registered
2 entity has to do something that you think is not
3 in your best interest, then you would look for an
4 unregistered entity because you would think that's
5 better for you or better for your clients.

6 MS. RUDGE: I would just like to add on
7 the smaller clients that are looking to hedge tied
8 to their exposures, I think that the access claim
9 is particularly important with respect to their
10 bank, if they don't offer the product in lieu of
11 being a swap dealer, they may not have access to
12 that hedging product, if you know the smaller
13 entities that are out there.

14 MS. COLLIER: From the local
15 government's perspective, the swap dealer is the
16 counterparty. We don't normally work through a
17 swap dealer to trade with another counterparty.
18 There have been instances where counterparties
19 have come through a swap dealer or through a swap
20 advisor to say we are interested in doing a swap
21 with this community, but we normally, as I said on
22 interest rate agreements, we normally have -- our

1 swap dealer is our counterparty.

2 It's important for us to know that there
3 is a broad market. Some swap dealers will deal
4 with small swaps, others will not. If that small
5 size swap -- and I'm talking about swaps less than
6 \$5 million -- if we only have large swap dealers,
7 those folks who are capable of managing a small
8 swap will not be able to enter the market. So we
9 have to have a broad range of swap dealers, and as
10 I said, our swap dealers generally are our
11 counterparties.

12 MR. FILLER: I think one of the
13 analyses, and maybe DMO can look into it, is what
14 is really the true quantity of what I call the
15 agency or direct client, direct counterparty
16 swaps. I would think it's a relatively small
17 amount versus where one of the counterparties is,
18 in fact, a swap dealer, and you have to then look
19 in the clear environment, as Mr. Cawley just said.
20 I mean I think it's a different element and
21 different approach from trading on SEFs and then
22 clearing the swaps through a DCO.

1 But in the uncleared environment, you
2 have to, again, look to the proposed regs on
3 uncleared swaps. Swap dealers have the right to
4 require margin, have the right to then -- the
5 client counterparties deposit in a custodial bank,
6 and how those filed rules I think are going to
7 come -- when they become adopted is really going
8 to have a more direct answer to your question.
9 And will those rules "be written in a way where
10 maybe the agency or direct counterparty swaps
11 might increase", so there's something for the
12 commissions to look into in the uncleared swap
13 environment, something to think about.

14 MS. BOULTWOOD: So I think, Mark, part
15 of your question around customer protection,
16 consumer protection is answered through the rules.
17 I think if you look back at the Banker's Trust
18 incident and the appropriateness of a derivative
19 for a particular customer, does the stamp of a
20 registration make a customer feel more comfortable
21 that they'll be dealt with more appropriately than
22 the non- registered dealer in that swap, say?

1 I can't say as a counterparty that I
2 would feel that the swap dealer stamp provides
3 that protection. I think part of it has to be
4 born by the counterparties in terms of
5 understanding the nature of the derivative
6 instrument they're entering into. The other part,
7 just by the reputation and kind of the broader
8 fiduciary, sense of fiduciary duties that swap
9 dealer feels they're carrying out. So --

10 MS. COLLIER: Also on uncleared swaps
11 for local governments, some local governments
12 cannot post margin requirements. That money that
13 they budget for debt service is authorized, it's
14 appropriated every year, and it's not always
15 convenient mid-year to go in and get an
16 appropriation. My General Assembly closed down
17 until next January at the end of May. If I needed
18 that appropriation to post a margin requirement,
19 we would have to call them into special session
20 potentially to post and get an appropriation to
21 post a margin requirement.

22 So we have to consider our process. Our

1 process is not a nimble process. We can't go in
2 and immediately transfer money. I have to have
3 generally 24 hours notice. My accounting
4 department tells me that if that request is not in
5 by 5:00 a.m. in the morning it will not process
6 that day. So that's a part of our business and
7 accounting process, and that's just one simple
8 example of timeliness of posting margin
9 requirements in local governments.

10 MR. FAJFAR: Go ahead.

11 MR. MASTERS: I was just going to make
12 one point. I mean, you know, everyone that is
13 transacting in uncleared swaps does have the
14 ability to require from a swap dealer to clear, so
15 that's -- and I think that's pretty important from
16 a lot of respects. And not only require the swap
17 dealer to clear the trade, but to clear it where
18 you'd like it to clear, in the sense of, you know,
19 so that's a big option that I don't think should
20 be overlooked by anyone with regard to this
21 discussion.

22 MR. FAJFAR: Okay. We want to leave

1 plenty of time for the de minimis exception. But
2 just to pick up the affiliate question that Ron
3 Filler mentioned, we said in the release that
4 generally there is some consideration to swaps
5 between affiliates, so I think the really useful
6 thing to talk about, to get any input on is, what
7 do we mean by -- if dealing between -- swaps
8 between affiliates are not dealt swaps, what do we
9 really mean by affiliate other than two wholly
10 owned, you know, twin --

11 MR. FILLER: Well, I think the analysis,
12 Mark, from a policy perspective is, if one of the
13 entities is already registered as a swap dealer
14 and then engages in what I call internal or
15 back-to-back swap with an affiliate within that
16 same organization, and you can define it as common
17 control or, you know, sister, brother, parent,
18 sub, whatever -- how you want to define it, does
19 that bring in the other affiliate to also become
20 registered, and fall within the definition, and
21 then become registered and have separate capital
22 and so forth?

1 So if one of the entities is already
2 registered as a swap dealer, does it cause -- and
3 does a swap with an affiliate, and you can define
4 affiliate any way you want, common ownership, does
5 that cause the other entity or affiliate to become
6 a swap dealer, as well? And that's the test that
7 the commissioners have to decide.

8 MR. HIXSON: On that issue, I mean we
9 would certainly hope that is not the case, and we
10 might do a back-to-back transaction when we hedge
11 an international commodity, we'd like to place the
12 futures in the Chicago pits, for example, and we
13 may have an affiliate transaction between two
14 governing entities in international jurisdictions,
15 you know, it's kind of an in-house, back-to- back
16 apparent guarantee of two corporate affiliates.
17 It doesn't make sense to us when we're already
18 fully margining the underlying hedge, so that
19 would certainly kind of be our view, is that, in
20 that instance, it doesn't really make sense.

21 MR. FAJFAR: Well, just to let the panel
22 lead the discussion, to me, it sounds like what

1 you're really talking about is, once an entity,
2 part of an entity is designated as a dealer, how
3 far does that designation extend? So since we're
4 there, that was the last point on the agenda, but
5 why don't we get into that, because the question
6 would be, just to tee it up a little bit, we
7 talked about dealing activities in the first
8 panel. If you had a company that now has come
9 around and says, okay, I am offering customer
10 swaps, I am within the definition of swap dealer,
11 but that's only some of the swaps, obviously it
12 would only be some of the swaps I use, there would
13 be other swaps that aren't in that same use.

14 How do you draw a line? And one of the
15 big questions is, does that same question apply to
16 what everyone seems to understand are the dealers?
17 Do the dealers -- because obviously even the
18 people that you acknowledge are dealers use swaps
19 for a lot of other reasons, so how would you think
20 that that would be cabined?

21 MR. TODD: Our institution, we obviously
22 use inter-affiliate trades, as do all of the major

1 banks that have multiple institutions that are
2 trading derivatives. But they're a critical
3 internal risk management tool that we need in
4 order to be able to centralize our risk
5 management. And conceptually, particularly
6 building on the discussions from the previous
7 panel, the fact that -- one of the key elements
8 that a number of the panelists raised the last
9 time, the focus on dealer activity being customer
10 driven, being based on making markets, you know,
11 all of those various criteria that we discussed in
12 the last panel, none of that is particularly
13 applicable to internal trades; they're pure risk
14 transfers.

15 MR. FAJFAR: What about beyond internal?
16 Are all of your external -- assuming that Bank of
17 America could be the type that would be a dealer,
18 would all of its external swaps be subject to the
19 dealer requirements?

20 MR. TODD: Well, we obviously have
21 components of bank that are sort of end-useresque
22 in terms of hedging our own balance sheet risk,

1 for instance. But based on how the regulators
2 have chosen to draft and conceive of the
3 definition of dealer itself, it's an entity based
4 approach. And so to the extent that any of our
5 non-dealer activities would actually be in an
6 entity that is also our customer facing entity, we
7 would expect that those activities would be
8 subject to any of the dealer requirements under
9 the current proposal.

10 MS. BOULTWOOD: I guess I would like to
11 advocate a different view that I think there
12 should be a limited designation of swap dealing
13 activities within a firm. Say the majority of the
14 firm is engaged in commercial activities and
15 hedging of those commercial activities but there's
16 a small piece potentially that there are
17 activities that could be considered swap dealing
18 if a broad definition of swap dealer is
19 promulgated. And in that case, we believe that
20 there are all kinds of issues that will be raised
21 around, you know, does it have to be a legal
22 entity, can it be a specific business division, a

1 subset of that division, does the company then
2 self-certify which piece of the business it is and
3 how it's kind of walling itself -- that piece of
4 the business off, and can we separate those
5 activities from the other activities of the firm
6 but then still utilize central, say, middle back
7 office infrastructures, central compliance staff,
8 and other kinds of central utilities of the
9 company.

10 So we believe that if a broad definition
11 is applied, and a small portion of a company's
12 activity could be construed as swap dealing, they
13 should be able to say that and designate this
14 limited area as a swap dealer and have the rest of
15 its business under kind of a self- certification
16 process understood as not being swap dealing.

17 MR. TODD: So if I could just add to my
18 comments, I wasn't indicating a different point of
19 view. We obviously would be supportive of a
20 definition that recognizes the fact that financial
21 institutions that act as dealers and make markets
22 for customers in terms of customer facilitation

1 trades, obviously they are in the business of
2 making loans and financing and that sort of thing,
3 where they have a balance sheet risk that they
4 need to hedge, similar, but obviously slightly
5 different in terms of the underlying business, but
6 it does have a similar component to corporate
7 end-users, as well, and we would certainly be
8 supportive of a similar construct.

9 MR. CAWLEY: Clearly under a corporate
10 umbrella, there is both opportunity for swap
11 dealing and also opportunity to be an end-user,
12 and I think that it would be fitting that there
13 clearly is some relief for those end- user
14 entities, legal entities, separated from the swap
15 dealer itself who have legitimate hedging end-user
16 purposes.

17 Now, you make mention in the rules on
18 the CFTC certainly with those which are deposit
19 institutions, and you can clearly see from making
20 a loan that there's a legitimate need. There's
21 also other balance sheet requirements that require
22 the use of be they credit swaps or interest rate

1 swaps to hedge, and there should be certainly
2 relief for that. That said, there should be a
3 certain distinction and delineation between the
4 swap dealer subsidiary and the other end-user
5 subsidiaries under that umbrella.

6 MR. MASTERS: Yeah, I just sort of echo
7 that, and maybe go a little further. I mean I
8 think you've got to be real careful when you sort
9 of go down that line in terms of Chinese wall kind
10 of considerations. I mean, certainly from my
11 perspective and many of the people I know in the
12 business, none of us trust Chinese walls
13 whatsoever, and as soon as you start dealing with
14 customers as opposed to being an end-user, then
15 it's a tricky place to be.

16 I mean, there's all sorts of things:
17 Who gets the information, how does the information
18 happen, and I think that that customer delineation
19 with regard to being a swap dealer, if you're
20 going to be in the business of being a swap dealer
21 and having customers, then you're a swap dealer.
22 I mean, you've got to be very careful in terms of

1 breaking that out, because it's just a different
2 business model, and if I'm not a customer, and I
3 can see the information from that customer flow,
4 all of a sudden I've got an asymmetric advantage
5 over other participants in the market.

6 MR. TODD: I think the fundamental
7 issue, though, with respect to how institutions
8 like ours organize our business -- I mean our
9 end-user treasury and sort of balance sheet
10 hedging business is completely separate from our
11 market making business.

12 I understand your concerns about Chinese
13 walls, but there's absolutely no way that somebody
14 that's trading in the customer facing business can
15 have access to the books or the price information
16 or anything else that the end-user entity, or the
17 end-user business is receiving. Those businesses
18 are physically, technologically and
19 compliance-wise completely separate from each
20 other.

21 MR. MASTERS: And with all due respect,
22 and I'm sure you do, I mean, we've never heard

1 that from any other swap dealer. I mean, in other words,
2 every swap dealer says the same thing, that
3 everything is isolated, nothing ever goes forward,
4 yet there's example after example after example
5 where somehow those things do cross over, so
6 that's the point.

7 MR. TODD: So are you, in effect,
8 basically saying that an entity that decides it's
9 going to be a dealer shouldn't be allowed to hedge
10 its balance sheet risk to the extent that it's a
11 financial institution that's offering loans to its
12 clients, for instance?

13 MR. MASTERS: No, I'm not saying that.
14 I'm just saying that from a regulatory
15 perspective, in terms of encompassing swap
16 dealers, there's a -- you have to be careful when
17 you're dealing with customers and then you're also
18 dealing from the standpoint of hedging your own
19 book. I mean it's a tricky business.

20 MR. TODD: We agree and think that a
21 robust conflict of interest and robust Chinese
22 wall mechanism would sufficiently protect those

1 two businesses from -- and keep them completely
2 separate.

3 MR. FAJFAR: I think that's really the
4 issue on the end-user, on the limited purpose
5 designation, is then would you have sort of a
6 Chinese wall, a bank type standard apply to the --
7 so I just want to be -- if anybody else wants to
8 kick in on that or is that sort of what the
9 thought is?

10 MR. HIXSON: Well, for Cargill, I mean,
11 by and large, we are a commercial company hedging
12 our own underlying physical movement of
13 commodities. We do offer customized risk
14 management products to customers that buy the
15 underlying commodity from us in terms of
16 compliance. We also then at times will have
17 customers come in and say, you know, we like your
18 cargo, but we don't want to buy all of our soy
19 bean oil from you guys, but we like your risk
20 management products, so they'll seek those risk
21 management products and perhaps not buy the
22 underlying flow of oil from us.

1 So from our standpoint, maybe we're
2 trying to make this too simple, but it seems like
3 there's a pretty clear delineation of anything we
4 would register with kind of dealer compliance
5 activities, based on kind of the fact you're going
6 to get all the swap data reported to you, and then
7 on those where we're serving a customer, where we
8 may not be selling them the underlying oil, we're
9 providing that swap data and acting as a dealer in
10 that capacity. So it's a small portion of overall
11 what we do, but certainly one where we're happy to
12 provide the transparency, I think, that will be
13 needed to, in a pretty simple way, distinguish the
14 two activities.

15 MS. BOULTWOOD: I'll just say we agree,
16 and it really does come back to kind of the
17 business purpose of the entity itself, and if it
18 can be defined most broadly as commercial, and
19 hedging the activities with derivatives hedging of
20 their own proprietary risks because they have
21 assets with served customers. Then it does make
22 sense that if their primary activity is this

1 commercial business then you could see a limited
2 designation required. But again, it depends on
3 how broad your definition of swap is and how broad
4 the definition of swap dealer is.

5 MS. RUDGE: Yeah, I just wanted to add
6 to that. In our particular institution, we would
7 have that bifurcated between treasury and any
8 business, but to the extent that a smaller
9 institution that was -- if it was a broad
10 definition, and to the extent that a smaller bank
11 was structured as an integrated treasury and very
12 small sales effort with clients for loan level
13 transactions or for foreign exchange client
14 related hedging, they may have a challenge in
15 doing that, in expressing that bifurcation.

16 But at the same time, if you look at the
17 activity, the activity is very specific to hedging
18 for themselves or for dialoguing around clients.
19 I think it really has to do with the broader steps
20 that were discussed earlier in terms of -- and
21 maybe it leads in a de minimis discussion, but
22 what is a broad effort in the industry and what is

1 more of a smaller or a smaller footprint and
2 smaller activity in the same construct of the
3 marketplace.

4 MR. FAJFAR: I just want to follow up
5 that -- can't help to draw the conclusion, in the
6 earlier panel, there was a pretty strong consensus
7 that the dealers are the large major financial
8 institutions and other sort of easily identifiable
9 people. The other market participants are not
10 identified as dealers, which would mean that those
11 people who are not dealers would not be subject to
12 any sort of Chinese wall requirement.

13 In fact, as far as -- tell me
14 differently, they would be perfectly free to use
15 the information that they glean from their small
16 amount of customer facing activity to then get a
17 better understanding of the market. There
18 wouldn't be an obligation that they share that
19 back, you know, that -- is that clear that that's
20 what we -- that's a good result?

21 MR. MASTERS: I think that's the exact
22 wrong result. I mean as soon as you're putting

1 customers into an asymmetric situation with a
2 counterparty that's one of the whole reasons we
3 had the crisis is, there was asymmetric
4 information out there, and in my view -- and that
5 of the de minimum exceptions and so forth. I mean
6 if you're going to be a swap dealer, be a swap
7 dealer; if you're going to be a hedger, be a
8 hedger, but as soon as you cross the line, there's
9 a lot of need for customer protection with regard
10 to preventing traders from misusing the
11 information. And again, you can have Chinese
12 walls and all the other stuff, but it just goes on
13 all the time.

14 And I won't name names, but there's
15 plenty of examples of that happening historically.
16 So I think that the customer actually needs the
17 protection that comes with the registration if
18 you're going to be engaged in that business.

19 MR. FILLER: Let me share my 35 years in
20 this industry, and we have these Chinese walls
21 built into futures, securities, and now it looks
22 like there's going to be some proposals on swaps.

1 I'm not aware of one enforcement action ever
2 brought by the CFTC, and I'm not sure whether,
3 from the SEC, that there's ever been a violation
4 of the Chinese walls, and you've got to
5 distinguish what we're talking about. Swap
6 dealers deal with customers.

7 As Greg was talking about, other
8 affiliates within the firm deal for themselves,
9 they're traders, not dealers. And, yes, I'm a
10 trader, I know that I did a deal with XYZ, but the
11 dealer part of it who deals a customer doesn't
12 share that information, there's a wall between
13 that, and you have to distinguish the trader
14 version versus the dealer version. It's been
15 there in the business, it's been in the futures
16 business, it's been in the equity business, it's
17 been there.

18 When you have customer information that
19 is confidential and is to be preserved and the
20 Chinese walls prevent it, what you do on the
21 trading side is a different animal, and you've
22 just got to have the proper Chinese walls to make

1 sure that the traders don't have access to the
2 customer side. And I'm not aware of any
3 enforcement action ever brought in the last 35
4 years in this area, so the system is working quite
5 well.

6 MR. FAJFAR: Stop me if I'm pressing
7 this too hard, but if -- the Chinese wall is
8 important. We established this morning that there
9 would be a lot of people offering customer facing
10 swaps that would not be dealers and would not have
11 Chinese walls. I mean not to pick on you, but you
12 said you wanted a choice between I'm going to do
13 the swap with a financial dealer, Chinese walls,
14 can't use my information, or I might go to one of
15 my peers, which you probably -- maybe you'd be
16 comfortable that they're not going to use it
17 against you, but they could if they wanted to, or
18 an energy firm. Now, if that energy firm were not
19 registered as a dealer, it could use the
20 information from the swaps it does with you for
21 better understanding of the market.

22 Now, I can see the argument is either,

1 well, that's just not going to happen that often
2 or it's not a concern, but I just want to make
3 clear that we were sort of saying customer
4 protections of the dealers are not important, but
5 that was one customer protection it seems you're
6 saying is very important, and I think it's very
7 important to the banks to show that they have
8 that, but the other market participants wouldn't
9 have that protection.

10 MR. FILLER: Well, the energy dealer
11 you're using in your example, which I agree with,
12 is trading on behalf of its own capital, it's not
13 dealing with a customer acting in it from a
14 counterparty perspective, it's a trader, not a
15 dealer. And, yes, when I'm a trader, I know I did
16 a deal with X, I did a deal with Y, and I did a
17 deal with Z, but that's information I did as a
18 trader, not in the dealer capacity, which is
19 almost more like an agency type capacity that
20 we're used to in our business. And, to me,
21 there's a big difference in acting as a trader
22 versus acting as a dealer, and if you are acting

1 as a dealer, and you have confidential client
2 information, there should be a wall preventing you
3 from sharing that information with the trading
4 functions within the same firm.

5 MR. BERMAN: Can I give that one a try,
6 Mark? Yes, but that depends -- so I think we're
7 using the word dealer two different ways. We're
8 using the word dealer as in someone who you can
9 call up who you all use today, and who some of you
10 are today, that's a dealer with a little D, that
11 has nothing to do with dealer in Dodd-Frank
12 because that doesn't exist yet.

13 Post-Dodd-Frank, now there's a dealer
14 with a capital D, that's a regulated entity. So
15 let's only talk about that one for a second. So
16 when you call a firm and you say I would like to
17 do the following swap, can you make me a market,
18 can you quote me a price, can you be my
19 counterparty, there will be entities who are
20 regulated with a capital D, who will have
21 requirements to make sure that there are Chinese
22 walls and that that information is not used.

1 If you engage with that same swap with
2 the dealer with the little D who's not regulated,
3 which many of you have just said you want to
4 continue dealing with, but at the same time said,
5 but we need those protections of making sure that
6 that information is not used, what Mark's point
7 is, those protections would not be granted. They
8 might be there, because the firm does their
9 business that way, but they're not regulatory
10 protections, and how would you balance the
11 difference between that?

12 MR. FILLER: Is the firm with the little
13 D a trader?

14 MR. BERMAN: The firm with the little D
15 is not a regulated entity.

16 MR. FILLER: Okay. But it's trading on
17 -- but using its own capital?

18 MR. BERMAN: It's not a regulated
19 entity, that's all.

20 MR. FILLER: Okay.

21 MR. BERMAN: It doesn't have to abide by
22 dealer rules.

1 MR. FILLER: Then from that perspective,
2 as I mentioned earlier, you've got to go DMO or
3 whomever from the SEC perspective, what is the
4 percentage of trades, what I call direct client or
5 agency trades are out there today, it's a very
6 small percentage, but it might increase, and
7 that's a concern you might have, and you have to
8 deal with how to deal with that. Either one has
9 to -- you're right, they might be unregulated, and
10 if I choose to deal with that other firm, I know
11 that that firm may be using that information, and
12 as others, John and others said earlier, we have
13 to evaluate the risk of our counterparties, and
14 they may determine that, no, I only want to deal
15 with the firms with the capital D.

16 MS. BOULTWOOD: They decide.

17 MR. FILLER: Yeah, let them decide.
18 Remember, we're dealing only with large eligible
19 contract participants in this deal.

20 MR. MASTERS: I would just say, I mean,
21 even though there hasn't been a regulatory history
22 with regard to the whole division here, as a hedge

1 fund manager the number one thing that I worry
2 about with dealing with a counterparty, number one
3 is that they're going to reverse engineer what I'm
4 doing, especially with regard to derivatives, any
5 kind of derivative transaction.

6 And so we consistently use markets in
7 which we can disguise what we're doing from the
8 standpoint of dealing with counterparties, because
9 that information is very valuable, and in the
10 wrong hands, it has potential serious
11 ramifications. And so from a customer protection
12 standpoint, I don't think there's any hedge fund
13 manager that wouldn't argue this, or most
14 portfolio managers, that's one of the biggest
15 things that they have to deal with day after day,
16 is to make sure that people aren't -- I mean
17 there's business models that are, in fact,
18 predicated on that, so I mean it's a really big
19 issue.

20 MS. BOULTWOOD: But, Mike, that would
21 speak potentially to being able to transact with a
22 broad diverse set of counterparties. Some are big

1 D, others are small D, and you're able to make the
2 decision based on your optimization of your credit
3 risk management, your liquidity, and other risks
4 you're trying to manage. If you take away the
5 little D, you've just limited your potential
6 partners, and you're more likely to be reverse
7 engineered.

8 MR. MASTERS: I don't think that the
9 customer protection issue is too big of an issue
10 for anyone in the market to deal with, I mean from
11 the standpoint -- I know this isn't part of this
12 panel in terms of business conduct, but I mean
13 it's a pretty serious issue to market integrity in
14 terms of -- that I know that whoever I deal with,
15 I'm going to get a fair shake whether I deal with
16 a big dealer or a small dealer. I'd like
17 everybody to have those protections.

18 MR. CAWLEY: Can I just -- but your
19 rules don't call for, with a capital D definition,
20 your rules don't call for -- the definition there
21 is really, by what we read, a function of whether
22 you hold yourself out as a dealer, whether you are

1 known in the marketplace to be a dealer, or
2 whether you make markets to counterparties.

3 And I think what I'm hearing right now
4 is, it's not making markets to counterparties,
5 it's making markets to customers. Certainly it's
6 fair to say that if you're dealing with customers,
7 and certainly coming from the securities
8 experience, we can all agree that there should be
9 certain protections when you're facing customers,
10 but surely the standard is different when you're
11 providing liquidity to a marketplace where you're
12 not facing customers. So a distinction, I think,
13 should be drawn there, whereas, on one hand you
14 say, well, look, we need to have dealers who will
15 be regulated and we need to know what they're
16 doing because of the systemic risk issue, and what
17 we're hearing from here is, from end-users is, you
18 know, we want to be able to still choose which
19 dealers we deal with, but some of them, we don't
20 want them to fall under the major swap participant
21 or major -- or swap dealer definition. So we want
22 to have our cake and eat it, too. And I can see

1 the tension there is, on one side, they qualify
2 and you get the protection; on the other, you
3 don't get the choice but you also don't get the
4 protection, so that's a clear tension that needs
5 to be figured out.

6 But again, coming back to it, your rules
7 don't talk about that you shall be considered a
8 dealer if you face customers. I think it would be
9 preferable if your rules did say that because
10 there are legitimate market makers in the space
11 who provide a greater systemic need, and we could
12 probably talk about this later, I don't know when
13 you're going to bring it in with the de minimis --

14 MR. FAJFAR: How do you distinguish --
15 when does a person change from a counterparty to a
16 customer?

17 MR. CAWLEY: When does a -- I think if
18 you hold yourself out to seek customer business,
19 you should be considered a dealer, and you should
20 be held to a higher standard than somebody who's a
21 trader in the marketplace.

22 MR. FAJFAR: But not if you seek

1 counterparty. A person who seeks counterparty
2 business would not --

3 MR. CAWLEY: Agreed.

4 MR. FAJFAR: -- how do we distinguish a
5 counterparty from a customer?

6 MR. CAWLEY: Well, if you go out and
7 market, if you have a sales force, and you'd
8 certainly talk about this in your rules, if you
9 have a sales force, if you hold yourself out as a
10 dealer, whereas if you're just in providing
11 liquidity to the market space and you have no
12 sales force, let's say you're connecting into an
13 exchange and you're sending prices electronically,
14 where you're not touching anyone and it's strictly
15 anonymous --

16 MR. FAJFAR: But are you saying that
17 whether the person is a counterparty or a customer
18 depends on what the "dealer" did to get there, if
19 they did this, they'd get --

20 MR. CAWLEY: Yeah, I think -- well, it
21 begs the definition of what a counterparty is. I
22 think a customer is a subset of a counterparty,

1 and the question is, who needs to be protected.
2 If you're trading with counterparties, you don't
3 necessarily know who they are if you're trading in
4 an anonymous all-to-all platform. So how do you
5 reconcile that then with protecting a customer?
6 If you're going out and holding yourself out as a
7 dealer, and facing customers directly, and even
8 holding customer funds on account at your
9 institution, to be sure, there should be
10 regulation around that.

11 MR. FAJFAR: Okay. Certainly people
12 here don't agree with that.

13 MR. MASTERS: I would just say I agree
14 with that, I mean in the sense of -- with the
15 whole notion of, you know, when you're facing DCM
16 or any kind of central counterparty, it's a much
17 different situation, because you have the
18 anonymity that you require.

19 And one of the participants here said
20 earlier, you know, we do our own credit analysis,
21 we do our own work on customers if we want to do
22 that, well, that's all information that I'd rather

1 not give you if I don't have to give it, and as
2 soon as I do give that information out, now you've
3 got an information edge on me potentially.

4 And so what I think theoretically we'd
5 like to do is to incentivize more use of DCM's,
6 because as soon as -- if I can move from that
7 bilateral information asymmetry world to a DCM
8 world, then I'm probably in a better situation
9 from a customer protection standpoint.

10 MR. FAJFAR: And I just want to make
11 sure we -- I just want to clarify. The point was,
12 the dividing line becomes when you know the
13 identity of the party, you've held yourself out or
14 somehow you've approached them that now you're
15 going to use the words accommodate, demand,
16 facilitate, they're entering into a swap, you know
17 their identity, that would be where we start to
18 get into the realm where we need customer
19 protection. But it seemed -- in the first panel,
20 there was a lot of argument that that's not
21 enough. There is more -- you need other elements,
22 you need to be known as a dealer.

1 MR. CAWLEY: Well, Mark --

2 MR. FAJFAR: -- only people who are
3 known as dealers need to register.

4 MR. CAWLEY: One other aspect, not to
5 add fuel to the fire, but I will, one other aspect
6 is, in your de minimis exceptions, you talk about
7 agency. Now, historically there's not a lot of
8 trades that occur on an agency basis today within
9 the swap market because of the bilateral market
10 context. But that is certainly going to change as
11 we move to a multilateral environment on
12 clearinghouses, where you certainly will have
13 entities who enter trades on behalf of customers.
14 So by your own rule, there is a tension there in
15 itself, because if you're trading against -- if
16 you're representing a customer on an agency basis,
17 shouldn't you also be held to some standard with
18 regard to ensuring that there's no conflict of
19 interest there or that you're ensuring best
20 execution on behalf of the customer?

21 So I think it's tricky. Does then the
22 swap dealer definition include not only that

1 you're facing customers, but you're also trading
2 on behalf of your own account, right, so does that
3 then become the dividing line?

4 MR. FAJFAR: No, dealers don't trade on
5 their own account, that's a trader, right?

6 MR. FILLER: Yeah, I don't necessarily
7 agree with that. I mean, I think dealers deal
8 with third parties, meaning non-affiliates, i.e.,
9 customers. And to answer your question, what's
10 the difference between a counterparty and a
11 customer, unless you're a dealer then every other
12 counterparty is a customer, okay. But I think
13 what Mr. Cawley -- you know, we're really in that
14 world of dealing 99 percent on a bilateral world,
15 and we're going to move to this traded cleared world
16 when that occurs. So what do we do between now
17 and then? And right now we're still in the
18 uncleared bilateral world, and how do we deal with
19 moving -- regulating these bilateral swaps, which
20 is the purpose of Dodd-Frank under Title VII, and
21 what is the proper regulation of OTC derivatives
22 during this period? And it's a different aspect

1 when you get to the cleared world versus the
2 bilateral world.

3 MR. FAJFAR: I'm sorry, what is your
4 response to the highly vocal opposition to the
5 clearing requirement? People are -- I could
6 characterize it, you know, with disgust. So are
7 you saying that they're wrong or that that's not
8 going to happen? Because it seems like the
9 uncleared world is something we really are going
10 to have to have our rules deal with. How can we
11 say -- I mean, if we said that a cleared swap is
12 not a dealt swap, how would that help?

13 MR. FILLER: Well, I think you raise a
14 very important issue. A lot of the commercial
15 end-users do not want to clear swaps, and I think
16 one of the main purposes is they don't want to
17 have to put up margin. And they prefer the
18 uncleared world, and they also want to not only
19 not want to put up margin, but also they want to
20 be able to customize a particular type of swap,
21 because once you go to the traded and clear world,
22 there's going to be more standard or customized --

1 whatever word you want to use -- and I think
2 that's going to be a very difficult policy
3 argument for the Commission, is how to deal with
4 those firms who qualify for -- or not required,
5 let's just say to be clear, and how to deal with
6 them for providing proper customer protections,
7 and at the same time, trying to provide the
8 benefits that they're seeking, as well. It's not
9 an easy answer to that question.

10 MS. BOULTWOOD: And I think if we're
11 just speaking about this migration and what will
12 happen for those end-users that would prefer to
13 just trade bilaterally and do their credit
14 analysis, have their own secured lines, they're
15 managing credit risk; for those end-users that
16 have decided to clear most of their transactions,
17 instead of managing the credit risk, which has not
18 disappeared, they're managing the liquidity risk.

19 And so you've really just traded one
20 risk for another. And for the company that's
21 doing both, they're simply optimizing between
22 credit risk and the amount of liquidity risk that

1 can be supported by their balance sheet. So I
2 think for many firms it's not one or the other,
3 it's the ability to optimize given the liquidity
4 profile of your company and your appetite for
5 credit risk, how are you going to get your
6 commercial transactions completed.

7 MS. RUDGE: And you may also find that,
8 again, tied to more banking product, where these
9 are hedges, are they commercial end-users that
10 they're -- it's just easier. They've already
11 pledged their assets to -- for the lending
12 perspective, and they may not have the wherewithal
13 due to their size to go enter the marketplace in a
14 much broader capacity.

15 MR. JANNEY: Oh, I'm sorry, speaking for
16 the public power in my own utility, in a lot of
17 cases what we do, it's impractical to have cleared
18 swaps because they do by nature have to be very
19 customized. To the extent there's a handful of
20 liquid trading, or transacting locations in the
21 electricity industry, it's very local. And if I'm
22 hedging an interest rate, an interest rate is an

1 interest rate across the whole country, it's all
2 the same. If I'm hedging grain, there's not a
3 huge distinction locationally between the price of
4 grain in Chicago versus Kansas City or Houston or
5 New York other than maybe a little bit of a
6 transportation differential. With electricity,
7 because of the nature of the transmission grid,
8 there can be huge differences between the price of
9 electricity in Seattle or San Francisco or Denver,
10 for example, and so our need to hedge our physical
11 exposures is highly locational in nature, and it's
12 impractical to have enough of a volume in each of
13 those locations that the swaps would be homogenous
14 enough to have a cleared product. So that's the
15 first issue with this cleared versus uncleared.

16 I think in our case in particular, and
17 many of the energy companies I think have a need
18 for the customized swaps. The other angle, and
19 this is sort of what Brenda got to, is that the
20 challenge with having to be forced to a cleared
21 product becomes one of liquidity, where as a
22 municipal corporation, we can't pledge collateral

1 in the sense of a lien on an asset.

2 The only thing we can do is revenue
3 pledges, and that falls into the whole stack of
4 our bond, our municipal bonds, and the debt that
5 we issue, and it's just much more of a challenge
6 for us to actually get a line of credit to be able
7 to back up some sort of a collateral posting
8 mechanism. And then in our case, in Washington
9 State, we don't have express authority to post
10 collateral. We're looking at implied authority,
11 but it's not yet crystal clear to us that this
12 collateral posting is something that's within our
13 authority to do except maybe in very narrow
14 situations, and so the ability to have the
15 over-the-counter bilateral non-cleared serves two
16 purposes for us: One, the customization to meet a
17 particular need to hedge our commercial exposure,
18 and number two, to manage the credit and liquidity
19 exposure that we have in doing that.

20 MR. FAJFAR: Let's move onto the de
21 minimis exception. And I think it would be useful
22 -- we have a half an hour, if I could just lay out

1 a couple of the -- just so people know where we're
2 going. I think the questions are, first, we're
3 from the general specific, you know, should the de
4 minimis be a threshold versus a multi factor test?
5 If it's a threshold, should the threshold be set
6 objectively, or should the threshold depend on the
7 person's own activity? And then whether there
8 should be different thresholds. There's a
9 question whether different types of activities
10 should have different thresholds, and also whether
11 the scale should be different. In other words, is
12 it simply a matter of applying the same scale
13 across the board or having actually different
14 scales for different types of activity? And then
15 there's the question of whether the de minimis
16 test should allow for this customer choice that
17 we've talked about. So, Josh?

18 MR. KANS: Yes, I would like to add one
19 more topic to that mix, and it's probably the most
20 fundamental of the topics, why should we have a de
21 minimis test? It's in the statute. But we've
22 seen comments that say it's all about systemic

1 risk, if you're not systemically risky, you
2 shouldn't be regulated as a dealer.

3 Some people talked about costs and
4 benefits and trying to quantify those into the de
5 minimis exception. Some have talked about
6 competition. So in terms of the entree to the
7 issue and the broadest aspect of the de minimis
8 exception, how people can address what should be
9 the guiding principle behind the rules that are
10 adopted.

11 MR. FAJFAR: So if anybody wants to
12 start with the -- so we'll start with the general
13 -- let's start with that point, what do you think
14 it's really there for?

15 MR. CAWLEY: So the tension is, and I
16 was here for the tail-end of the first panel, as I
17 understand it, the tension is, on one side you
18 want swap dealers to have oversight, and on the
19 other side it's tough to sort of plan into
20 something that does not exist. So let's talk
21 about different types of principal and agency
22 transactions and do they fall in. I mean it's

1 certainly fair to say that, as I mentioned
2 earlier, that very few agency dealers or brokers
3 exist today where they act in an agent capacity to
4 execute swaps on behalf of end-users or customers.
5 That's going to change as clearing goes into
6 effect and as counterparty risk goes away and now
7 you're facing the clearing entity, the DCO.

8 There's certainly a whole number of
9 agency based broker dealers that exist and perform
10 quite well today in the securities markets, and
11 they provide a legitimate function as they make
12 money for themselves by bringing liquidity and
13 research and so forth, they just don't carry the
14 positions at the end of each trading day, or
15 sometimes they do, but to a limited extent.

16 These institutions, as this market moves
17 toward cleared, provide a very fundamental
18 function to the marketplace, vis-à-vis liquidity,
19 whereas today, you have a bilateral structured
20 context where you've got really only dealer to
21 customer trading flow, vis-à-vis, liquidity. Now
22 what you're looking at is, in a mutualized or a

1 multilateral context, the ability to also have
2 customers trade with customers, dare I say it, but
3 also customers trade and provide liquidity to
4 dealers. In fact, if you talk to some customers,
5 large and small, from the liquidity crisis, and
6 that's really what it was back in October, 2008,
7 they'll say, hey, you know, we actually had to
8 provide liquidity to people who we were told were
9 our liquidity providers.

10 So what you're dealing with there is --
11 you're opening up the spigots of liquidity, which
12 I think we can all agree is a good thing for the
13 marketplace. Why? Because liquidity brings
14 transparency, ultimately brings lower transaction
15 costs, and certainly when you need it most in
16 times of dislocation it's fair to say that the
17 markets don't operate, and what you see on CNBC
18 during the course of the day is these lovely
19 continuous marketplaces, they do gap, right, and
20 that's the reality of the marketplace. So more
21 liquidity is good. So agent/broker dealers
22 entering the space and helping facilitate that

1 liquidity is a good thing.

2 If they're operating on behalf of
3 someone else, do they qualify under the de minimis
4 exception? I would say and we would say they do
5 and they should. That said, those institutions
6 should be held to some standard recognizing their
7 fiduciary obligation to their customer. I don't
8 know where you reflect that, but it certainly
9 should be there, whether they do it themselves and
10 the customers can make those decisions themselves
11 and say, look, we're going to choose broker/agency
12 dealer A over agency dealer B because they assure
13 us that they have these Chinese walls and rule
14 books and so forth and we feel that there's a
15 greater competency and that they're not going to
16 be using trading against our positions.

17 And that really brings it back to the
18 notion of -- are on dealing desks, notwithstanding
19 Mr. Filler's assertion to the contrary, which is
20 -- the truth is that dealer desks do actually hold
21 proprietary positions and in addition to making
22 markets operating on a strict matchbook basis, but

1 coming back to de minimis exceptions.

2 I think it's fair to say, and it's a
3 tough sell to say that there's agents that are yet
4 to exist because the market doesn't exist. I only
5 like vanilla ice cream because I don't know what
6 chocolate is. And the benefits -- so that's one
7 aspect.

8 When you consider the other aspects,
9 though, it really comes back to do you face
10 customers, is that something that feeds into the
11 customer -- into the definition of a dealer? I
12 think it should. Should a customer -- should a
13 dealer be considered and face -- and be excluded
14 from the exemption because they trade a threshold
15 amount of swaps? Maybe they should. I don't
16 think that the number -- we could talk about this
17 is 100 million, which sounds like a lot of money,
18 but it's really, on a DVO1 basis, in five years,
19 it's about \$42,000 of risk.

20 MR. FAJFAR: Anybody else?

21 MS. RUDGE: Yeah, I was just going to
22 add, in the previous panel, that discussion about

1 the participation in the marketplace and potential
2 participants leaving, if they were deemed a swap
3 dealer, and I think that part of that comes to
4 somewhat of an unknown in terms of what the
5 compliance standards and what needs to be
6 implemented in a smaller footprint business.

7 So you may have, and again, I'm kind of
8 speaking more for smaller banks, you may have a
9 small commercial oriented derivatives business, so
10 there are designated staff for that, however,
11 they're helping clients who are hedging their
12 underlying risk, and these entities in and of
13 themselves are rather small in scale by number of
14 people, they have to have a certain hurdle to
15 enter the business, but if that hurdle for entry
16 or to sustain existence is much higher, you may
17 find that either some don't enter or some leave.
18 And as that occurs, I think that kind of access
19 discussion that we had earlier for the clients,
20 and again, maybe the comment of a small D and
21 little D, but also maybe a big C and a little C in
22 terms of clients and their ability to access the

1 marketplace and how they do that and in what means
2 they do that and do they want to make the effort
3 to do that or do they just go unhedged.

4 MR. FAJFAR: Then just to reiterate,
5 you're saying basically the de minimis is, you
6 balance compliance costs, whatever those may be,
7 we're not sure, versus the level of -- basically
8 the revenue from the activity, and you should --
9 if the revenue from the activity wouldn't justify
10 the compliance cost, yet we still think it's a
11 wise thing to do, that should be the de minimis
12 standard.

13 MS. RUDGE: Well, actually I think
14 that's -- what I was drawing back to, it really
15 goes to where to define your swap dealer, and at
16 that baseline of where you define that, whether
17 it's wide or more narrow, and if it's very wide
18 and you encompass the small participants in the
19 marketplace, then you have kind of a core
20 challenge. If it's more narrow, then, of course,
21 the de minimis exemption doesn't become quite as
22 relevant. So I think really kind of starting

1 there, and I know you need to talk about this
2 specific test, but it really kind of gets down to
3 dealing characteristics. Because I think that not
4 all dealers, while you may offer a product, you're
5 not at that same participation in the marketplace,
6 whether it's by the scale of what you're doing,
7 the risk that you're taking and offering it, and,
8 you know, as those are defined, at whichever part
9 of the definition they become defined in, those
10 are kind of the core characteristics I think in
11 terms of -- that are important, because there is
12 some measure of your size, in terms of if you're
13 going to be able to handle the registration
14 regulation.

15 MR. FAJFAR: So just to clarify, the de
16 minimis is an exception, it's different, it's an
17 exception. It says you're a person that engages
18 in swap dealing, so you're already -- the question
19 is, we have a person who engages in swap dealing,
20 but we're going to except them out of the
21 definition. And so the two questions are why, and
22 then how do we decide which dealers do we except

1 out through the de minimis exception. So take it
2 as a given, you have to give the definition of
3 dealer first.

4 MR. FILLER: Well, I think, as Camille
5 mentioned, I think answering the why from Josh's
6 and your question is, what's going to be the
7 definition of swap dealers, and that's going to be
8 a very important narrow or expansive. But dealing
9 with the quantity tests, if I read it correctly,
10 there are three tests, you know, if you had a
11 notional value of 100 million over, I think, a
12 rolling 12 months and 20 or 25 swaps in any one
13 year or whatever, I read it to mean that if I did
14 one swap for a billion dollars, I'd lose the de
15 minimis. And so --

16 MR. FAJFAR: As a dealer, right?

17 MR. FILLER: As a dealer. And so,
18 therefore, should it be -- the three tests --
19 should it be either of the three? In other words,
20 if I do under 20 swaps in a year, regardless of
21 the notion of value, is that something, or is it
22 maybe I'm just throwing this out for a discussion

1 among the group here and for the commission staff
2 to consider, or is it a number swaps, is it the
3 notional value of the swaps in that rolling
4 period?

5 I think if you're going to have a narrow
6 definition, it may not be as important. If you
7 have a larger, more expansive definition, it's
8 going to be a more critical analysis. And the
9 question is, I only do one swap, but it's more
10 than 100 million, I lose the exemption. Is that
11 really what the intent is, to want that one firm
12 doing one swap, being registered as a swap dealer?

13 MR. MASTERS: I don't think that's the
14 case, is it? I mean if it's -- in my
15 understanding, it's a quantity, but it's not -- is
16 it exclusive, is that --

17 MR. FAJFAR: No, Ron's right, the way
18 the rule is written, but I --

19 MR. MASTERS: So there's --

20 MR. FAJFAR: -- I think you'd have that
21 issue no matter -- whenever you have a bright
22 line. If we -- a lot of people said basically a

1 \$3 billion de minimis level, under that test you
2 do one swap, \$4 billion, one swap, one swap, \$3
3 billion, whatever it is, it's -- so -- and the
4 comment is basically evenly split on whether we
5 should look at notional value or quantity. Some
6 people said one or the other, so there was no
7 consensus there.

8 MR. CAWLEY: So just with that, though,
9 I mean, again, the question of innovation, if you
10 are an agency dealer looking to become a principal
11 dealer or a larger dealer and you do one swap, and
12 the average ticket -- an average two year swap is
13 400 million, and an average CDS IG trade is 75
14 million, so you can run through that pretty
15 quickly. But if you just look at it on a PNL
16 basis as a dealing desk, I'd say, so I'm going to
17 go out, and the bid ask spread in IG index is,
18 let's call it a basis point, so if I quote one
19 trade, I stand to make \$43,000, assuming it's a
20 five year swap and the DV01 is 420 per million,
21 which is it. So then the challenge is, is that
22 worth my while to invest in becoming a swap dealer

1 to do, you know, because there's going to be a
2 pretty significant -- it's going to require a lot
3 more money than \$42,000, and I'm going to blow
4 through that limit pretty quickly, so what's in it
5 for me to -- I've got to be pretty sure I'm going
6 to develop and innovate and be successful as a
7 swap dealer before I make that leap.

8 MR. BERMAN: But I think, to Mark's
9 point, you first have to meet the definition of a
10 dealer. A single transaction for a billion dollar
11 swap once a year, it may be very difficult to say
12 how is that person a dealer, why would anybody
13 have a business where they do one swap a year?
14 Well, they might be an end-user, they may have a
15 million reasons to do that swap, but would that in
16 itself be dealing?

17 So first you have to say that the way
18 you're actually engaging the transaction is
19 dealing, then the question is whether or not you
20 meet the de minimis. So I think it's a bit of a
21 red herring, the whole -- if you did one
22 transaction, because I'm not sure -- unless you

1 came up with some dealing model where you only did
2 one transaction a year.

3 MR. CAWLEY: Well, you know, one thing
4 is, if you have an agency guide, they're in the
5 business of transactions, the question is, are
6 they matching them on an agency basis or are they
7 becoming -- or are they putting their own capital
8 at risk, right, are they standing in there. So
9 you could also do it the other way and say, well,
10 if I do \$100 million transactions, I'm still only
11 making \$42,000, so is this worth my while?

12 MR. FAJFAR: But your point -- where
13 you're going, you're clear -- you're okay with a
14 threshold, it just has to be set at the right
15 place. But, again, not to peg Camille, but I was
16 basically saying you compare the cost of
17 compliance against the revenue from the swap
18 dealing, and we get to a place where we're
19 comfortable, and then that gives you -- that's
20 your threshold, whatever revenue would get you
21 over compliance cost is -- then that's where the
22 de minimis bubble is.

1 MR. CAWLEY: Agreed.

2 MS. RUDGE: Yeah, I just think it would
3 be hard to put a value on that. I think
4 conceptually it would be nice to be able to do
5 that so that you could have more entrance and it
6 could be set at a relative level. But, you know,
7 another concept that I've seen out there is
8 actually your open risk position or your, you
9 know, there's uncollateralized positions, there's
10 a lot of -- not so much notional traded, because
11 different kinds of swaps have different exposures,
12 and whether they're offset or not, there's
13 different exposures.

14 So you could also look at something that
15 goes to whether or not the exposure is directly
16 offset, into the marketplace, and how the end
17 result is retained and what those numbers are.

18 MR. KANS: If I can follow up on that,
19 though, there's ideas of either tying the de
20 minimis tests to revenues or de minimis tests
21 exposure measures. What other things could be
22 lost? I'm thinking in particular about customer

1 protection issues, that is, if we base things
2 solely on revenues, exposure, there still is the
3 opportunity then for dealing with small entities,
4 special entities, and you may be losing the
5 benefits of customer protection that aren't going
6 to be picked up in these other models. Anyone
7 care to comment about that?

8 MS. BOULTWOOD: Yeah, I think, Josh, it
9 goes back to an earlier discussion, where we were
10 talking about the risks of consumer protection,
11 and had there really been incidents, have there
12 been regulatory judgments where that hasn't been
13 the case, and is that risk really that large
14 versus the risk in the market of losing a large
15 number of participants who no longer qualify to
16 transact with their counterparties, customers,
17 because they have pulled out of the business for
18 fear of the costs of holding themselves out as a
19 swap dealer, given that their business model is
20 not dealing -- it's perhaps other commercial
21 purposes.

22 So I think you're never going to have

1 one or the other, you're balancing the two types
2 of risk, and you have to ask yourself, is it worth
3 limiting market participation, the amount of
4 transparency, the bid offer spreads, your ability
5 to get reliable price quotes because you have so
6 few participants versus broadening the market,
7 having more participants, and having the potential
8 vagaries of consumer protection.

9 And it is a big risk, all of us would
10 rather deal with entities that have the
11 segregation, have the Chinese wall, but, you know,
12 we do our due diligence to try to make sure that
13 it happens with the counterparties we're
14 transacting with, but it becomes the
15 responsibility of the participant, not something
16 you regulate.

17 MS. RUDGE: I'm sorry, I was going to
18 say, I would add for IDI's that the client and
19 their types of transactions they do based on their
20 needs are not at the extreme sophisticated
21 spectrum in terms of market products. This isn't
22 about products but you are really looking at a

1 specific segment of the clients that have a very
2 kind of defined use, over-the-counter derivatives
3 that are about hedging their exposures typically
4 in that example.

5 And with that comes, I think, not that
6 the consumer protection isn't very important, but
7 the access to the marketplace and to having the
8 institution be able to offer the product, and for
9 the banks themselves to be able to offer the
10 product because it diversifies their revenue, and
11 it also provides a greater return on that client's
12 lending business that they're already doing. So
13 there's a lot of kind of interplay I think between
14 that specific part of the market.

15 MR. BERMAN: A number of commenters have
16 pointed out to the diversification of the
17 different counterparties and the choices. I think
18 we can pull from the equity markets and learn a
19 little bit about the nature of liquidity. I know
20 my colleague, Andrei, and I spent a lot of time on
21 the May 6th Flash Crash on liquidity.

22 In the swap market, at least in a lot of

1 the "more liquid markets", a vast, vast majority
2 of the transactions have a very small number of
3 dealers on one side of that. So the offsetting
4 for many of the counterparties that you're talking
5 about, they're doing another transaction which
6 eventually is going to get to that dealer.

7 So we have to think about the system as
8 a whole, that the diversification is 1,000
9 different parties that I can deal with, but if 990
10 of those parties all have to then deal with the
11 same 10 parties in the end, that diversification
12 is still there, but it may not be affording the
13 protection that might appear on the surface. So
14 when we think about this, we have to think about
15 the system as a whole, including the fact that it
16 actually is a very concentrated market in the
17 aggregate.

18 MR. KIRILENKO: If I may add to what
19 Gregg just said, and that concentration is partly
20 a result of sort of the natural consolidation
21 forces that over time happened in the industry, so
22 it just may have started out a lot more -- it was

1 a lot more participants, and over time, it
2 aggregated to just a few participants who merely
3 focus on one particular asset class and are really
4 good at it.

5 MS. BOULTWOOD: So is that commentary
6 leading to the conclusion that you expect there to
7 become a more concentrated set of participants
8 then?

9 MR. BERMAN: No, not --

10 MS. BOULTWOOD: Because that can happen,
11 you know, with the right rules, but --

12 MR. BERMAN: Right, no, the commentary
13 was not --

14 MS. BOULTWOOD: -- an assumption here is
15 that there are competitive markets and you want
16 many to be able to participate. If it's a
17 foregone conclusion we're going to get to greater
18 concentration as the right answer, I think that's
19 where you'd find a lot of disagreement amongst the
20 panel about whether that's best for all the
21 commercial participants in this market.

22 MR. BERMAN: Right; no, I -- the

1 commentary was not meant as a judgment on -- even
2 a prediction on what's going to happen. So to
3 Andrei's point, I think market forces are going to
4 drive the market where it goes. My comment was,
5 when we say we need to have different types of
6 thresholds for de minimis, because we need to be
7 very careful about not shutting out somebody who
8 is able to offer a product that otherwise could
9 not necessarily have been offered, we have to take
10 that knowing that that product is only really
11 offerable because there's a larger system in the
12 background, and that you can always go back to
13 that larger system.

14 So we have to keep that in mind as we
15 think about -- and we'll just mostly ask you guys
16 to keep that in mind as you think about what the
17 effect of the de minimis threshold will actually
18 wind up being.

19 MR. JANNEY: You do bring up a good
20 point, but I think tagging on what Camille and
21 Brenda were saying earlier from an end-user
22 perspective, there's this big market backdrop --

1 back there with people transacting amongst each
2 other, but from our perspective to the extent that
3 it limits the amount of potential counterparties
4 or dealers that we can deal with we've got maybe a
5 fairly narrow range of prices that were being
6 offered. If we limit the number, then that range
7 is going to narrow even more, and it's going to
8 end up ultimately costing us more money. And then
9 that credit angle is the other one, if we're
10 transacting in the customized swap market it's
11 going to mean that, at some point, that dealer or
12 counterparty isn't going to want to transact with
13 me anymore because he's full up to here with
14 exposure with my particular company or whoever
15 they're trading with.

16 And so, again, anything that shrinks
17 down or limits the competition in the market is
18 going to have a cost implication and a risk
19 implication at least for the end-user community.

20 MR. MASTERS: I would just say that,
21 just in terms of the cost, I mean obviously I have
22 conflicting views with regard to customer

1 protection, but with regard to the cost issue, one
2 of the things that we proposed in our comment
3 letter was the desegregation of credit cost to
4 end-users, so they could actually see what
5 everybody says what's going to cost me more money
6 to go to a clearing regime, in fact, it may not
7 cost you more money to go to a clearing regime
8 because you're already paying the freight. I
9 mean, you may not know you're paying the freight,
10 but you're paying it. I mean, people aren't doing
11 these services for free. And so if, in reporting
12 swaps, if part of that swap reporting, and this is
13 a little bit off the subject, but I mean just in
14 the sense of -- from a customer standpoint, if in
15 reporting that, I could see the disaggregated
16 credit cost, then I think that I may have
17 different perspectives on it.

18 MR. CAWLEY: Just one thing I think
19 that's important to make the distinction on is the
20 difference between necessarily a dealer and a
21 liquidity provider to the space, right. Again,
22 either there are liquidity providers in other

1 markets that provide lots of liquidity, and in so
2 doing, provide a more stable market, one might
3 argue, but don't face customers.

4 And maybe when you're, again, drawing
5 back to it, as you're attempting to make the
6 distinction, do they face customers, and
7 therefore, do they need the requisite Chinese wall
8 provisions and so forth versus encouraging the
9 liquidity into the space.

10 MR. FAJFAR: So there were a lot of
11 comments and a lot of you have said that the de
12 minimis should serve to encourage diversity and
13 decrease concentration, and I would just ask from
14 a government regulator's perspective, is that
15 something a government regulator should do? And
16 then how would we implement that -- or how would
17 you envision that that's -- would that standard be
18 different across different industries? If you
19 were in our shoes, how would you say, okay, I want
20 X amount of diversity, but not Y amount? How is
21 that really implemental in a regulation?

22 MS. BOULTWOOD: I guess we would put

1 forward that you would -- assuming we go with the
2 very broad definition of a swap dealer and now
3 we're looking to exempt entities from that
4 definition, you would understand that the top
5 broker dealers, in regulating them as swap
6 dealers, you've captured 99 percent of the gross
7 notional of your outstanding interest rate, FX
8 commodity swaps, right.

9 So you've captured the vast majority
10 already, and then you'd look at that which you
11 haven't covered, and Camille talked about the cost
12 benefit, but this would be kind of at an aggregate
13 level, what's the benefit of going after
14 additional entities and not allowing them to
15 qualify for a de minimis exception?

16 And we would say, because you want that
17 diversity of counterparty, you would want to
18 establish a de minimis criteria where one of the
19 groups that proposed 3 billion used some math to
20 get there, but small banks are given the 10
21 billion, but you look at the \$600 trillion
22 notional derivatives market, it seems very small

1 for the benefit that you derive in terms of the
2 diversification and broadness of your potential
3 market. And I would propose you'd start very
4 simply and ask firms to self-certify, declare,
5 maybe there'd be a questionnaire that they would
6 fill out about the nature of their broader
7 business and why the CFTC would consider -- or the
8 SEC would consider -- exempting them for some
9 small portion. How would that portion of their
10 business be organized, what rules would they apply
11 internally, and then force the firm to be able to
12 report on those regularly or at any time to you as
13 regulators?

14 And it puts the burden on the firm
15 asking for the de minimis exception to prove that
16 they're in compliance with the criteria.

17 MS. RUDGE: So I'll just add to that, as
18 the entities that are considered to be dealers as
19 that is defined, getting to the point Brenda just
20 made, then you can look at what is remaining, and
21 at that point it may be very hopeful to look at
22 the construct of the different types of

1 participants and how they enter into the
2 marketplace, who their clients are, what their
3 activities are, and that might help you rather
4 than saying it should be three billion or it
5 should be X billion at this point, because I think
6 that it gets to the character in terms of the size
7 and scale by nature of the clients or the
8 underlying use or purpose of what they're doing, I
9 think it will fall out.

10 I don't know, I can't say that this is
11 the number, but I think that that will begin to
12 show itself, whether it's in open risk positions
13 or in notional traded or in asset size of the
14 firms.

15 And I think it's, at least speaking from
16 the banking perspective, I think it's pretty
17 commensurate with asset size of organizations and
18 their underlying client bases that they serve,
19 gets them into certain parts of the marketplace
20 that are very specific as opposed to broad
21 ranging, and they're not dealing necessarily with
22 many other swap dealers, they might be dealing

1 with small man size corporations, high net worth
2 individuals, and perhaps very small FI's as
3 opposed to other larger dealers as clients, and
4 that begins to kind of form the nuance of the
5 different tests.

6 MS. SANEVICH: I think, just listening
7 to the first panel and listening to the various
8 participants, the thing that keeps coming back to
9 me is that there are lots and lots of very unique
10 users, whether they be natural end- users, special
11 entities, financial entities, and we all have our
12 own views as to, you know, we collateralize and
13 vice versa with counterparties, so this concept of
14 risk analysis for us, while it exists, it is not
15 nearly as critical as the folks here who do have
16 collateral, you know, have maybe posted no
17 collateral.

18 You know, for us, a clearing world,
19 particularly with the margins proposed currently
20 for uncleared swaps might be better, but for the
21 fact that the segregation issue is still looming
22 out there, and so from our perspective, that might

1 actually make us in a riskier position than we
2 currently are.

3 And so this kind of makes me go right
4 back to, you know, this is a huge, huge market,
5 and there's really not a lot of information for
6 the regulators to really base these very important
7 and critical decisions on who's a broker, and what
8 should the de minimis rule be. Well, it's hard to
9 figure out what people are actually doing and who
10 is a dealer. So this law of unintended
11 consequences is important for all of us. I think
12 that's probably why there's so much push back on
13 clearing, is because we haven't done it before, so
14 we're all petrified. And it's not that people
15 don't like clearing, per se, you know, we use
16 futures and that works really well, but none of us
17 know how it all fits together, and the systems, I
18 mean, kind of everything that you all have heard
19 in the past. And so that might argue for starting
20 out with -- define a dealer to catch the 50/20
21 whatever dealers, collect the information, and
22 then see who's missing. And it doesn't have to be

1 five years, it could be a year or whatever, but
2 then you would have a better sense of what makes
3 sense from a de minimis carve out, or who's not
4 getting caught that you really do think should be
5 caught.

6 And I know the agencies have these
7 policy-making ramifications to what they do with
8 every single rule that's out there, and I think
9 this is just another example of how very specific
10 end-users have very particular issues with
11 whatever aspects you do. I mean it's a very
12 difficult job, and I think it's made that much
13 more difficult without the right information,
14 because there isn't that information out there
15 available to you.

16 MR. CAWLEY: Yeah, I would agree with
17 that. It's tough, it's tough to figure it out,
18 because not only is it tough to find that
19 information to get a sense of where the market is
20 today, but also it's where the market is going to
21 be once clearing goes effective, and how the
22 landscape is going to change, and the more

1 prescriptive you get in a rule, the more likely
2 you probably are to be wrong. So what I would
3 say, though, when you look at notional amounts,
4 probably you will create inconsistencies in the
5 marketplace if you set notional amounts and not
6 look at it on a risk adjusted basis.

7 So certain tools you can deploy into a
8 prescriptive approach. The other thing is, one or
9 the other rules or requirements is that you limit
10 it to 15 counterparties. How would that work if
11 you're facing a clearing or a SEF or an exchange?
12 I mean that's another limitation. But it's tough
13 work.

14 MS. COLLIER: Yes, when you're talking
15 about the number of dealers that can participate,
16 from a special entity perspective, I have to say I
17 want the broadest number of dealers that there are
18 available. Let me change the situation for a
19 minute to give you an example.

20 If I'm bidding bonds at competitive
21 sale, there are many bonds out there every day in
22 the market, and whether you're going -- you as an

1 investment banking firm are going to bid on my
2 bonds or not, there are many factors. When I get
3 down to trying to enter into a swap, an interest
4 rate swap, as most of my entities do, the market
5 is even smaller. The market gets smaller then
6 because of the size of the swap, because of my
7 credit quality, and so I am very limited then in
8 whom I'm going to deal with.

9 Now, I'm eventually going to negotiate
10 with a selected dealer, but generally government
11 wants a competitive process to select that dealer.
12 And the more competitors that I have, the better
13 off as a special entity I'm going to be.

14 I need to have a dealer to work with who
15 will offer transparency. I need a dealer who's
16 going to disclose more than would have to be
17 disclosed in an agreement with a private entity or
18 when private entities are involved in the swap.
19 And I need to demonstrate that there is no
20 conflict of interest, there's no conflict of
21 interest between the swap advisor, and the dealer,
22 and there is no other conflict between the special

1 entity, any of its participants, and the dealer.
2 So to get to that specific dealer who's going to
3 meet all of my requirements takes a broad universe
4 of dealers who can then be narrowed down and
5 filtered through to get to that point, who's going
6 to be a successful and competent dealer to deal
7 with a special entity and its requirements.

8 MR. BERMAN: Just to make sure I
9 understand, I'm trying to think up comments, I'm
10 not sure which side you're arguing on. So are you
11 saying that there should be more regulated
12 dealers, and again, the key here is regulated --

13 MS. COLLIER: Sure.

14 MR. BERMAN: -- or less regulated
15 dealers so that there are more non-regulated
16 dealers?

17 MS. COLLIER: Big D.

18 MR. BERMAN: So you would --

19 MS. COLLIER: More regulated big D
20 dealers.

21 MR. BERMAN: So you would want a larger
22 universe?

1 MS. COLLIER: Yes, because depending on
2 my requirements in my particular case, I need a
3 large universe to offer my particular interest to.

4 MR. JANNEY: Mary-Margaret, can I ask a
5 question on that, because I'm trying to understand
6 on that one. So you're saying that you would be
7 restricted from transacting only with regulated
8 dealers, and that if there were other dealers --
9 small D dealers out there that met all your
10 criteria, you wouldn't be able to transact with
11 them?

12 MS. COLLIER: I think that for many of
13 us that would be the case. We have certain
14 criteria. If we're sending out a request for a
15 proposal, we're going to have a lot of criteria,
16 and so we need a large number of people who can
17 meet that criteria. I don't think that the small
18 folks, de minimis folks are going to be interested
19 in us, because our swap may not meet their needs,
20 so we need to have the biggest universe of people,
21 because when we put that RFP out to be our swap
22 counterparty or to be the dealer that we're

1 negotiating with, we need to have a big universe
2 of people who could compete because there aren't
3 going to be that many who will compete because of
4 our special needs.

5 MR. JANNEY: Yeah, I see what you're
6 saying, I just don't know that there might be an
7 unintended consequence there. If we try to expand
8 the definition of a regulated dealer, it may
9 disqualify some dealers because they don't want to
10 be regulated, they can't cover the cost, and so it
11 could unintentionally reduce the number of dealers
12 that you're able to deal with if we expand the
13 scope of what a regulated dealer is.

14 MS. COLLIER: I think that's something
15 that needs to be discussed further then and get
16 more opinions on how many of these dealers would
17 participate with special entities, because I know
18 when I'm looking at my small special entities,
19 they're going to be very few dealers who will deal
20 with them, and they have the same criteria as the
21 largest of the large.

22 MS. SANEVICH: So I see by Mark's smile,

1 I bet he knows what I'm going to say, but I feel
2 compelled to say it anyway. Not all special
3 entities are created equal, and that is part of
4 the problem with seeking through what to do for
5 special entities.

6 There are pension plans, you know,
7 private pension plans and public pension plans who
8 do not have any of these issues and have very
9 different concerns and problems, including quite
10 significant absolute barriers, and so that was it.

11 MR. FAJFAR: But just on the point they
12 were -- you only deal with the big D dealers --

13 MS. SANEVICH: Right, so --

14 MR. FAJFAR: -- so that's just not
15 relevant to you, what they're talking about?

16 MS. SANEVICH: It's not -- it was just a
17 special entity. We're small, nobody, you know,
18 fewer people to deal with. That is absolutely not
19 true in our case, we deal with the big banks, who
20 I expect every single one of them will be a
21 dealer.

22 MR. KIRILENKO: It's interesting that

1 the concept of liquidity being fragmented among
2 multiple dealers is gaining so much traction. I
3 keep going back to your comments, that there is a
4 difference between who the dealers are and where
5 the liquidity is. Dealers may or may not
6 necessarily be providers of liquidity. You can
7 have one exchange that provides a very, very
8 liquid market and brings together many, many
9 counterparties and can do lots and lots of things
10 for you, yet there is only one venue. You can
11 have few venues where the liquidity meets, not
12 necessarily those that provide liquidity. To me
13 it seems a bit like an extension of the current
14 thinking -- the bilateral thinking that is
15 liquidity is just synonymous with the number of
16 providers, yet is that necessary how you're
17 thinking of that?

18 MS. COLLIER: When we enter into a
19 transaction as a general government and we are
20 entering into an interest rate hedge, we've issued
21 variable rate debt for 20 to 30 years generally,
22 and using the GASB 53 standards to have an

1 effective hedge, we are entering into a hedge that
2 matches the maturity of that debt. So we have to
3 have a dealer, a counterparty that is going to be
4 there for that period of time. When I get down to
5 I have questions about whether smaller dealers
6 would be there, I have questions about measuring
7 risk, I have to keep measuring risk over time, I
8 have small governments that can't measure risk,
9 they need a swap advisor or a financial advisor
10 who's constantly measuring the credit quality of
11 the counterparty. So to the extent that I have a
12 strong dealer community, big D, that is regulated,
13 and gives me some additional assurance, I need
14 that.

15 MR. CAWLEY: But that doesn't exist in a
16 cleared world, right, because you don't have
17 counterparty risk to manage if you're facing a
18 clearing house, so I certainly see an environment
19 where you would have a swap advisor who would
20 advise the special entity, via-a-vis the ongoing
21 exposure as the swap rolls out a curve or goes
22 through time.

1 But to your point, I think it's fair to
2 say that it's a tough sell to sell. You know,
3 end-users are on the benefits of a mutualized all
4 to all exchange like trading platforms when none
5 actually exist today. So the frame of reference
6 is, indeed, the bilateral marketplace. So, you
7 know, and it's tough for you guys because you're
8 trying to provide for how the world is going to
9 look once we have clearing, and -- but to your
10 point, you know, which I mentioned before, you
11 shouldn't confuse liquidity on one side with
12 dealers on the other. You can do that today
13 because it's one way liquidity, it's dealer to
14 customer.

15 MS. COLLIER: Correct.

16 MR. CAWLEY: But there's certainly -- if
17 you take an exchange environment, we'll usually
18 trade in the New York Stock Exchange, for example,
19 in the equity context, you have liquidity coming
20 from the exchange itself. You're sort of
21 indifferent as to who the buyer or who the seller
22 of, you know, who the liquidity provider is in

1 that transaction.

2 MR. FAJFAR: I think we're going to have
3 to stop because there's a lot of considerations
4 that go into the dealer definition, so we'll just
5 have to stop at this point. Thanks. We'll see
6 you at 2:00 for the MSP, which is much simpler.

7 MR. KANS: Well, thank you for showing
8 up. This is the third and final panel of today.
9 The focus of this panel will be on the definition
10 of "major participant". And, we have some new
11 people attendant, so could everyone just go over
12 and reintroduce themselves, please?

13 MR. THUM: Sure. I'm Bill Thum from
14 Vanguard. I'm a principal and I'm in the legal
15 department focusing on derivatives regulation.

16 MR. MASTERS: Michael Masters, Better
17 Markets.

18 MR. KYLE: Pete Kyle, University of
19 Maryland, finance professor.

20 MR. NEVINS: Matt Nevins, Fidelity
21 Investments, legal.

22 MR. OPPENHEIMER: Ron Oppenheimer on

1 behalf of the Working Group of Commercial Energy
2 Firms.

3 MR. STANLEY: Marcus Stanley from
4 Americans for Financial Reform.

5 MR. KANS: Thank you. The definition of
6 major participant has a number of different
7 criterion and is a much different test than the
8 dealer test. So, a lot of the issues are
9 substantially different from the dealer issues.

10 The way I think we're going to have this
11 panel is, for the first third or so of the panel
12 we're going to focus on some of the rationales
13 behind regulating major participants. Because
14 that's a somewhat novel definition within the Act
15 that's not found in a lot of other places.

16 The second third, we can focus on some
17 of the specific tests that have been proposed in
18 connection with identifying who is a major
19 participant. And we'll reserve the final third of
20 the discussion to talk about one specific issue
21 that's raised by the definition, which is hedging,
22 mitigating commercial risk. What does it mean to

1 be hedging and mitigating commercial risk.

2 So as Mark said this morning, some of
3 the panelists are focused on one or more
4 particular issues, so their silence on other
5 issues, obviously, does not mean anything.

6 With that said, I want to toss out as a
7 fundamental issue, in terms of interpreting the
8 definition of major participant as it appears in
9 Title 7, what exactly should the regulators be
10 seeking to accomplish? What are we trying to
11 capture? The definitions themselves do speak in
12 terms -- they use language that alludes to risk
13 and risk criteria. There are different types of
14 risks that could be embedded. Counterparty risk
15 is one definite type of risk that is embedded.

16 But there also have been views expressed
17 that in addition to the risk posed by an entity or
18 the counterparty risk posed, the definition could
19 also subsume issues about the significance of the
20 entity in the markets as a whole. For example, if
21 an entity has to quickly liquidate its positions,
22 even if there's no default, how would that impact

1 the markets?

2 So one core question really is, are we
3 talking only about counterparty risk? Or are we
4 also talking about risks that are inherent in a
5 large position within the market.

6 And a second fundamental question I'd
7 like to tee up for people to comment on is, how
8 significant does the risk have to be? Obviously
9 there's the definition used as the term systemic.
10 And whatever systemic means itself is something
11 that's open to debate. But we're talking about
12 issues that are -- risks that really have to be
13 systemic to the economy as a whole, or can we talk
14 about -- does the definition also encompass the
15 sorts of risks that go -- drill down less deeply
16 and affect the counterparties more directly and
17 maybe the markets, but not the economy as a whole?

18 So, I'd like to toss out those two
19 fundamental issues for people's comments.

20 MR. THUM: Hi, Josh. I think those are
21 excellent questions. And just to try to level set
22 with respect to Vanguard.

1 Vanguard operates 170 registered mutual
2 funds, has 9 million shareholder accounts and
3 about \$1.6 trillion under management. It uses
4 derivatives to hedge portfolio risk, lower
5 transaction costs, and achieve more favorable
6 execution. Our derivatives trading, which is
7 fairly conservative and generally small, is fully
8 collateralized on a bilateral basis. The
9 collateral is held in triparty accounts with a
10 fund's custodians. And in looking at the 2008
11 market disruption, Vanguard funds were able to
12 apply the pledged collateral that had come in the
13 door to address the market value of its swaps, and
14 it was also able to recover the collateral that it
15 had pledged to the dealer from the fund's
16 custodian that was holding the collateral.

17 We agree with what was written in the
18 release that the major swap participant definition
19 targets non-dealers, which could pose a high
20 degree of risk to the U.S. Financial system. And
21 we also agree with the comments noted from the
22 Senate colloquy between Senators Hagan and

1 Lincoln, that the goal of the MSP definition was
2 to focus on risk factors that contributed to the
3 recent financial crisis, such as excessive
4 leverage, under collateralization, and a lack of
5 transparency about aggregate position size.

6 We feel the test does address the
7 appropriate risks. We have concerns around the
8 edges in terms of the tests being over complex to
9 actually perform. We also feel some aspects of it
10 need to be refined to better reflect not only
11 existing market practice but also some of the more
12 recent rules that have come out, particularly the
13 margin rules in terms of initial margin
14 requirements for un-cleared swaps. But as a
15 registered funds -- as register funds present it,
16 none of the risks associated with the financial
17 crisis. And robust regulations already apply with
18 respect to their swaps usage.

19 We feel that the registered funds,
20 ideally, would be exempt from the category of
21 major swap participant. But if not exempt, that
22 we would be able to come up with a safe harbor

1 test where the funds would not be required to
2 perform the rather complex tests on a regular
3 basis until the risk approached -- until the usage
4 of swaps on an uncollateralized, un-cleared basis
5 approached certain thresholds.

6 MR. NEVINS: So, thank you, Bill. I
7 could probably summarize my comments with two
8 words and say I agree. That was an excellent
9 overview and summary. We at Fidelity agree with
10 much of what -- actually, all of what Bill just
11 covered.

12 From our perspective -- to answer your
13 questions, Josh -- the way we think about the
14 rulemaking here is it's intended to get to those
15 non-dealer entities that have the potential to
16 create risk to the financial marketplace if their
17 swap positions need to be unwinded. So, if
18 there's a default, then you'd look at what the
19 impact would be on the overall financial system.
20 I think that seems to be the most important policy
21 behind the definition of major swap participant.

22 We think that you've done an excellent

1 job in trying to create a rule that matches up
2 with that policy goal to capture those entities
3 that would have the possibility of creating that
4 kind of financial systemic risk. I think, as has
5 been mentioned on several occasions and on a
6 stated -- in the proposed rule release itself, we
7 understand the intent to be that the MSP
8 definition is intended to pick up a handful --
9 maybe two handfuls -- of actual players in the
10 marketplace, and we support that notion as well.

11 To get to the question about the
12 particular risks and counterparty risks in
13 particular, we think that it's an intelligent way
14 of designing the thresholds and the tests to have
15 a test based on current uncollateralized exposure.
16 We do believe that collateral is the lynchpin of
17 protection, the most important thing to be looking
18 at when you're determining what kind of risk could
19 be created to the system to the extent that you
20 have collateralized positions. We don't feel that
21 there really is any risk. So we think that's the
22 most important test.

1 We also understand the Commission's
2 view, though, that collateral may not get 100
3 percent of the way there because you also need to
4 look at size and that counterparty risk -- the
5 potential for there to be an actual systemic
6 financial failure to the extent that there are
7 humungous swap positions that aren't
8 collateralized in the marketplace.

9 So, we think having that second
10 potential future exposure prong does make sense.
11 We think that it's very appropriate to include the
12 discounting that you propose based on risk factors
13 both on types of swaps and the tenor of swaps. We
14 think that it makes complete sense to have
15 discounting for clearing. In fact, we would
16 support cleared swaps being removed from both the
17 current uncollateralized exposure test and the
18 potential future exposure test completely. So to
19 have not just an 80 percent discount, but a full
20 discount for cleared positions.

21 We also agree with the notion of a
22 discount for daily mark to market margining, as

1 well as for netting. So, we think that you've
2 included the right factors here, they're the right
3 factors to be looking at. We're very supportive
4 of the thresholds. We think that it's completely
5 appropriate to pick up the -- to pick up the small
6 number of entities that could have that systemic
7 risk to the system.

8 MR. STANLEY: So, I just wanted to make
9 three points on behalf of AFR in response to your
10 question. One is that we believe you should be
11 looking more broadly at risks to the market as a
12 whole, and not only default risk. One of the
13 things that we saw in 2008 was that companies that
14 were highly leveraged and had to liquidate a lot
15 of assets quickly had a big impact on asset prices
16 in the market. And then that, then, put pressure
17 on other companies in the market. And that's --
18 you know, financial panics can work through
19 bilateral relationships between companies or they
20 can work through asset prices on the market as a
21 whole. So we think that's something to pay
22 attention to.

1 A second is just to underline something
2 that was mentioned here, which is the importance
3 of thinking about future exposures when it comes
4 to collateral. Particularly with certain kinds of
5 securities-based swaps, but also with the kinds of
6 swaps the CFTC is going to be looking at, there
7 can be highly discontinuous collateral demands. I
8 understand when Constellation Energy in 2008 --
9 there was -- they sort of determined by looking at
10 the credit support annexes to some of their
11 agreements that they owed \$1.6 billion more in
12 collateral calls than they had originally believed
13 they owed. And that was --

14 MS. BOULTWOOD: That was downgraded --

15 MR. STANLEY: That was a downgrade.

16 MS. BOULTWOOD: That was a downgrade.

17 MR. STANLEY: Right. But, as I
18 understand it, a downgrade can lead to collateral
19 -- calls can lead to significantly more collateral
20 demands than might be expected at a company's
21 current credit rating. And I think that's the
22 kind of thing that you have to look for and look

1 ahead to.

2 So, the kinds of situations that you see
3 in downgrades with additional collateral demands,
4 I would think, would be something that the
5 Commission should look toward as potential danger
6 for a company.

7 And the third point was that the major
8 swap participant definition is not only about
9 prudential risks -- and you can tell this because
10 the prudential -- there are banks and companies
11 that are already subject to prudential regulation.
12 And in fact, their prudential regulator will
13 govern their capital and prudential standards.
14 But they are still required to register. And
15 presumably, the reason for that is that there are
16 informational and business conduct kinds of
17 standards in the designation that are also
18 important.

19 So.

20 MR. MASTERS: I would just highlight
21 there's a couple of bold positions that we
22 highlighted in our comment letter with respect to

1 Better Markets.

2 The threshold that the Commission
3 determines to be prudent for the effective
4 monitoring, management, oversight of entities that
5 are systemically important or can significantly
6 impact the financial system. And then secondly,
7 exposure that could have serious adverse affects
8 in the financial stability of the United States
9 banking system or financial markets being the key
10 second part of that.

11 Which you know, in our view, doesn't
12 necessarily only look at systemic consequences.
13 In other words, it's not just systemically record.
14 It's -- even if you have a fully collateralized
15 position, you can still be market-moving, from
16 that standpoint. And contribute to instability in
17 the marketplace. So, just in terms of the
18 language, that's what we see.

19 And the other thing that I would say is,
20 with regard to the exposure being reduced, you
21 know, using a central counterparty or a clearing
22 -- that makes a lot of sense to us. We think that

1 absolutely should be the case.

2 However, if a position is marked daily,
3 you know, even if it is fully collateralized we
4 have a bit of a problem with that because you
5 could still have a problem. And that sort of goes
6 to the downgrade point that Marcus is making. In
7 our view, it makes sense in the one -- from a
8 central clearing regime, but not in the second.

9 MR. NEVINS: I would just respond to
10 that briefly, Mike. That the proposal does not
11 give full credit for daily mark to market
12 margin, correct? It's an 80 percent haircut.
13 So I think that they've acknowledged that that
14 doesn't get you all the way there. But I'm very
15 supportive of the notion of having the requirement
16 to post on a daily basis being -- having an
17 appropriate haircut applied. And we think that is
18 very logical to include at least an 80 percent
19 haircut for that.

20 MR. KANS: And we'll have a chance to
21 talk about those specific issues a little bit down
22 the line. But I also want to apologize. I forgot

1 to introduce Terry Arbit with the CFTC as a fellow
2 panelist. So, my apologies, Terry.

3 MR. FAJFAR: Pete, do you want to say
4 something?

5 MR. KYLE: I'll say something. I think
6 that when you're trying to come up with criteria
7 for these significant participants, you mainly
8 want to look at whether -- if they started losing
9 money on their positions, they'd have to delever
10 those positions and essentially dump them on a
11 market in a destabilizing manner.

12 If we look at past history, we can see
13 two financial crises that directly related to
14 derivatives. One was the Hunt silver squeeze
15 around 1980, the commodity markets. And the
16 second one was the LTCM crisis. You could also
17 throw the 1987 stock market crash in there with
18 the portfolio insurance. So there are three kind
19 of financial crises, all of which involve
20 derivatives.

21 But the -- two of them, the Hunts and
22 LTCM involved entities that were highly levered.

1 The Hunts had made highly levered investments in
2 silver, LTCM had made highly levered investments
3 in fixed income securities. So the question of
4 whether their positions are fully collateralized,
5 to me is much less important than the question of
6 whether, given an adverse market move, they're
7 going to be forced to liquidate and whether that's
8 going to create a potential financial crisis.

9 MR. FAJFAR: I just had a follow-up
10 question to Marcus and to you, also. You didn't
11 say whether the current definition -- do you think
12 it captures -- you talked about, you know, looking
13 beyond the downgrade or -- well, these different
14 factors should be taken? Or do you think the
15 definition should be changed to take something
16 into account? I wasn't clear on your position on
17 that.

18 MR. KYLE: Let me address that by
19 example. Let's -- an example I use in my classes
20 at the University of Maryland. Let's compare
21 Warren Buffet and AIG. They're both involved
22 heavily in derivatives, they both had significant

1 exposure to negative shocks to the economy, which
2 was going to cost their companies billions of
3 dollars. Buffet had a company that was not very
4 highly levered, so no matter how negative the
5 shock he wasn't going to have to post collateral
6 and he was going to be very stable and he was not
7 going to be destabilizing the financial system.
8 In fact, he might have been supporting it by
9 doubling up on his positions.

10 On the other hand, you had AIG, which
11 was highly levered. And it structured their
12 derivatives so as soon as a bad event happened --
13 which could have either have been a downgrade,
14 which did happen, or a margin call from Goldman
15 Sachs, which also happened, they were going to
16 have a financial crisis which was going to unravel
17 their firm, and that's what happened.

18 So, I think you should carve out a
19 definition that respects the fact that Warren
20 Buffet is a lot different from AIG, and Buffet's
21 firm causes much less systemic risk than AIG-type
22 firm causes. And it --

1 MR. THUM: If I could just try and
2 clarify in my own thinking. The current exposure
3 test picks up effectively uncollateralized
4 exposure. And that would, in my mind, at least --
5 I've been thinking in terms of looking at the
6 market value of the trades versus the collateral
7 that was in the door.

8 Now, if you had a ratings-based
9 collateral trigger that said you didn't need to
10 post any collateral at all because of the rating,
11 then you would have to count 100 percent of the
12 market exposure for the purposes of this test,
13 because you hadn't posted any collateral. So, I
14 think this test actually mitigates the risk that
15 there could be ratings triggers in the credit
16 support annexes or in the collateral documentation
17 because it will pick up those situations where if
18 you are highly rated and you've agreed with your
19 dealer not to post collateral -- assuming that
20 could go on in the future given the new margin
21 rules -- that this test will pick up that
22 uncollateralized exposure at that point.

1 I think also the potential future
2 exposure test picks up the additional risk. That
3 from the time an entity becomes insolvent and can
4 no longer post collateral to the time that its
5 counterparty can effectively give notice of
6 termination, can close out the trades, and can
7 liquidate the collateral that it holds, that its
8 counterparty is protected based on historic
9 volatility analysis as to market -- potential
10 movements from the time the counterparty last got
11 collateral in the door to the time it can
12 liquidate and apply that collateral.

13 So, I think your test -- the beauty of
14 your test is that it not only looks at current
15 exposure, current mark to market exposure with
16 respect to the swaps trading positions, but it
17 also has a component that addresses volatility so
18 that you are addressing the additional risk that
19 is posed by the length of time it takes to close
20 out trades, apply the collateral, liquidate the
21 collateral, and apply the proceeds.

22 So, I don't -- my sense is that the

1 ratings issue is actually addressed, effectively,
2 by the rule because if you're not posting
3 collateral because you have a high rating, you're
4 going to have to count the full exposure of the
5 positions in this test because it will be
6 uncollateralized.

7 MR. BERMAN: That certainly was the
8 intent of the dual current exposure and potential
9 exposure, which is not something that we made up,
10 that's been used by banks and clearinghouses.

11 But I'd like to come back to something
12 you said, Pete, about the leverage aspect. I
13 think in addition to the ratings concept, which I
14 think you pick up, what aspect of leverage would
15 we -- are we missing? Because I would imagine
16 that if you were levered, then you would not be
17 able to afford the collateral calls. So, you
18 would be taking a hit immediately.

19 So in AIG's case, I think that would be
20 perhaps different from Buffet's case. So, is
21 there some way, again, to Mark's point -- is there
22 something that we should be changing in the rule

1 because you think there's an element that we're
2 not capturing?

3 MR. KYLE: Well, I think if you have,
4 let's say, two swap market participants that are
5 of equal size and one of them has a huge amount of
6 capital and the other one has the bare minimum
7 amount of capital to sustain its positions, then
8 the one with the bare minimum amount of capital to
9 sustain its positions poses much more systemic
10 risk than the one with the huge capital buffer.
11 Because, if the one with the minimum amount of
12 capital has an adverse market move is going to
13 start liquidating its positions to meet margin
14 calls. Whereas the one with huge capital buffer
15 can ride it out and maybe even add to its
16 positions as markets move adversely.

17 So, you need to take into account, I
18 think, the level of capitalization of the
19 entities. And that's the biggest difference
20 between Buffet and AIG, that Buffet was not very
21 levered. That's why he had a AAA rating, that's
22 why he didn't have to make margin calls. But the

1 economically important issue behind that is that
2 Buffet would not have had to delever if the market
3 had moved against him, which it did and he didn't
4 delever.

5 MR. BERMAN: So, I think I understand
6 what you're saying. But again, I'm trying to
7 think about how one transcribes that into a change
8 in the actual rules. So from a -- if you did not
9 have sufficient capital, the instant the market
10 started moving from you, your current exposure
11 would blossom and you'd immediately be captured.

12 I mean, if I had no money, my current
13 exposure is zero on day one. I'd be \$1 positive
14 or negative, which would be infinite times my
15 capital.

16 MR. KYLE: But you don't want to capture
17 somebody after it's too late.

18 MR. BERMAN: Right, so --

19 MR. KYLE: So, you want to capture the
20 Hunt brothers while they're building up their
21 position, not while they're liquidating it.
22 Because that would be too late.

1 MR. BERMAN: So that's why -- would that
2 imply, then, looking at the potential future
3 explore -- and you couldn't look at the future
4 exposure because -- assuming it's zero. But you'd
5 look at the potential future exposure and somehow
6 measure that with respect to a capital base
7 instead of just on absolute level --

8 MR. KYLE: Yeah, potential future
9 exposure given that the firm maintains its
10 positions without liquidating any, contemplate
11 adverse scenarios that that firm might face and
12 then ask how adverse a scenario can that firm
13 survive without having to get involved in a forced
14 liquidation?

15 And so the answer with the Hunt brothers
16 was, not much. LTCM, not much. AIG, not much.
17 But Buffet was pretty solid.

18 MR. BERMAN: So does that make the test
19 -- would that make the test more inclusive, then?
20 Or less -- it sounds like it would make the test
21 less inclusive. Because you --

22 MR. KYLE: Yeah, I'm not sure --

1 MR. BERMAN: You would say, take the
2 existing test, which is just absolute. So, we're
3 basically assuming you have no money to cover.
4 And what you're saying is that, but there may be
5 firms that have sufficient money to cover. So
6 therefore, if you also compare that with your
7 capital base, there might be firms from your
8 perspective that might meet both those tests but
9 would fail the third test.

10 MR. KYLE: Right, so if the firm --

11 MR. BERMAN: And therefore would be out
12 --

13 MR. KYLE: -- if a firm kept its
14 positions and raised a lot more capital, that
15 would potentially enable it to say, okay. Take us
16 off the list of major market participants, which
17 is exactly the incentive structure you would like
18 to have in place. Which is, incentives to be
19 well-capitalized.

20 MR. FAJFAR: Would it be as simple as
21 having -- keeping the same tests but just taking
22 the thresholds and sliding them by a capital?

1 Instead of a -- you know, whether tranches or
2 percentages, the different thresholds would apply
3 depending on the capital level the company has.
4 Is that --

5 MR. KYLE: I think that might be how it
6 would play out in practice.

7 MR. MASTERS: Or are you talking about
8 sort of a value at risk sort of standard with that?

9 MR. FAJFAR: No, no. I'm saying, keep
10 the test the same, just the threshold changes
11 depending on the capital level of the company.
12 So, a company with this much capital has a
13 threshold, a company with that much capital has
14 this threshold.

15 MR. THUM: I think -- I mean, our view
16 is that the test is -- currently addresses the
17 right risks. And indeed, is fairly complex. We
18 have, as I said earlier, been looking for an
19 exemption for registered funds. And on some
20 level, what has been said resonates with that
21 request in that the registered funds are required
22 to segregate assets related to their trading.

1 So interestingly enough, for a
2 registered fund you're not only posting 100
3 percent of market value but you're segregating
4 some assets related to your trading position. At
5 this point, many registered funds do not post
6 independent amounts to reflect potential exposure.
7 But of course, if the proposed margin rules are
8 put in place, both for the cleared world and the
9 un-cleared world, registered funds will have to
10 post collateral to address that risk.

11 So, I suppose that the test could have
12 an additional exclusion based on high
13 capitalization or segregation of assets, even if
14 deals were fully collateralized. But again, I get
15 back at the test. I feel -- we feel that the test
16 addressees the appropriate risks and is extremely
17 complex at present. And I would be reluctant to
18 see an additional level of complexity.

19 I think if we look at AIG versus Warren
20 Buffet, you know, my understanding of the AIG
21 scenario was that it was not posting margin
22 because of its rating. Now, certainly the market

1 moved against it from that point. But certainly
2 on day one, it had exposure that was
3 uncollateralized that would be relevant for the
4 purposes of this test, regardless of its rating.
5 If this test was in place, it's possible AIG would
6 have been picked up even before the market moved
7 against it and a collateral call was made.

8 So, I think the answer and the thing
9 that the Commissions want to encourage is full
10 collateralization is that if you put a test like
11 this in place, entities like AIG that have a
12 ratings-based collateral threshold where they're
13 not posting collateral may be encouraged to
14 actually post collateral so that they don't fall
15 into the categorization of major swap participant.

16 But we feel that across the board, the
17 matrix of new rules, including central clearing
18 with collateralization both for market value and
19 initial margin, new margin rules for over the
20 counter trading going forward, all address risk
21 issues. The major swap participant test is
22 effectively picking up things that fall through

1 the cracks where you could conceivably have an
2 entity that is not posting collateral, not
3 clearing trades, has a significant exposure, and
4 needs to meet certain capital standards, reporting
5 standards, and the other issues related to major
6 swap participant status.

7 So, we're comfortable with the risks and
8 the tests, notwithstanding that I think if you
9 were to add an additional carve-out for capital
10 levels, you might actually capture fewer entities.

11 MR. NEVINS: I would just like to add a
12 couple comments to this discussion. First of all,
13 just to remind folks, there is a prong of this
14 test that includes a highly leveraged calculation
15 as well. So I think that the whole concept of
16 leverage is already being woven into really the
17 statutory definition and the rulemaking that's
18 come out of it.

19 And I want to pick up on a point that
20 Bill made, because it's been an important one for
21 our industry. We have been very supportive of the
22 notion of an exemption completely for registered

1 investment companies. I would also put out that
2 we would be supportive of an exemption for ERISA
3 plans and accounts. Both are highly regulated
4 today and have limits on their ability to use
5 leverage, as Bill was alluding to. The '40 Act
6 has requirements to cover positions that
7 essentially limits the amount of leverage that
8 registered investment companies can use. So it
9 would be extremely helpful, from our perspective,
10 if funds that aren't leveraged and don't have the
11 ability to use leverage and really don't create
12 that level of risk could be exempt altogether.

13 Falling short of that, we would be very
14 supportive -- as Bill alluded to earlier as well
15 -- to a notion of a filter or a safe harbor from
16 having to do daily monitoring and daily testing of
17 the thresholds for any participants really that
18 are so far below the thresholds that it wouldn't
19 seem likely to be triggered. So, that's something
20 that I would be highly supportive of as well.

21 I'll take this opportunity to also
22 throw out my support to the Commission's view

1 that's contained in the proposed rule to look
2 solely at a fund-by-fund basis in applying these
3 tests, and not attributing the swap positions of
4 the funds that we manage up to the asset manager
5 and aggregating across different funds. We think
6 it's absolutely correct to be looking at each fund
7 and each portfolio, really, within an investment
8 trust on a separate basis that's the level where
9 risk is created. It's the level where exposure
10 exists, and it's the level of recourse that our
11 counterparties look at.

12 So, we would -- you know, encourage the
13 Commissions to continue down that road. The one
14 clarification that we've asked for in this space
15 is in the separate account space. So, where we
16 have separate accounts that are owned by a single
17 beneficial owner but possibly have multiple
18 advisors where the documentation for the swaps of
19 those separate accounts clarifies that recourse is
20 cut off at the account level. We think that the
21 Commission should respect where that recourse
22 resides, as opposed to requiring aggregation up to

1 the beneficial owner level.

2 MR. KYLE: So, let's -- the example that
3 comes to my mind -- to interpret your comments --
4 is portfolio insurance in the 1987 stock market
5 crash. So there you had one kind of advisor, LOR.
6 You had a number of different companies that were
7 implementing the same strategy, most of which were
8 highly un-levered pension fund-type entities. It
9 created the 1987 stock market crash, which we'll
10 recall was a 20 day -- 20 percent drop in the
11 S&P 500 in 1 day, and 100 basis point or something
12 movement in interest rates in the opposite
13 direction on the same day. So it was certainly a
14 huge systemic event, and people knew about it at
15 the time.

16 You know, early 1987 even months before
17 it occurred the SEC and the CFTC both were
18 concerned about it. And the SEC did a
19 multi-hundred page study of what would happen if
20 these strategies blew up.

21 So it would seem to me that whatever
22 your definition of major swap market participant

1 is, it should include entities like LOR that were
2 associated with the 1987 stock market crash. And
3 it seems like your definition might have given
4 them an exemption.

5 MR. THUM: I think it's important to
6 keep in mind to bring us up to date, you know, to
7 2008 or let alone now that in the most recent
8 market crisis -- significant one involving Lehman
9 Brothers as I said at the outset -- the registered
10 funds that we manage and, indeed, registered funds
11 generally are required to receive collateral, post
12 collateral, have collateral held by a third party
13 custodian. And that collateral was adequate to
14 cover the market risk, and the collateral that had
15 been posted was returned to the fund. So, that
16 collateral is posted and is, indeed, negotiated in
17 contract with the dealers on a fund-by-fund basis.
18 Collateral levels are set with respect to the
19 trades that are actually done that each fund is
20 party to.

21 And it does seem to make sense, and
22 certainly based on the most recent market

1 experience that if you have exposure related to a
2 single legal entity and that legal entity's
3 exposure is fully collateralized, that it is not
4 posing significant risk to the financial system.
5 And therefore, again, I say that your test is
6 picking up -- it's addressing the right risks,
7 it's giving credit where, indeed, you want to
8 drive the market, which is to clearing and
9 collateralization. And we feel -- we agree with
10 Matt that we feel the registered funds and,
11 indeed, ERISA plans do not present the risk and
12 are separately, heavily regulated in terms of
13 their investments. You're really targeting a
14 different animal here, both in terms of a lack of
15 regulation and in terms of the level of
16 un-cleared, uncollateralized swap trading.

17 MR. FAJFAR: I would like to just ask a
18 clarifying question. First, what you said about
19 registered investment companies. Do those same
20 protections apply to separate accounts -- the
21 collateralization requirement, the leverage
22 requirements? And would your idea about not

1 attributing, would you have that apply even when
2 the separate account where there's at least some
3 level of control from the upstairs investor of the
4 separate account's transactions?

5 MR. NEVINS: Sure, so -- good questions,
6 Mark. The -- to answer the first one, it depends.
7 So, there are lots of different types of owners of
8 separate accounts. So there are separate accounts
9 that are ERISA accounts. And in those cases,
10 where you're governed by a body of regulation that
11 restricts what you can and can't do, I would say,
12 yes. It falls into the same category as
13 registered investment companies.

14 Otherwise you know, to be intellectually
15 honest here, you know, it's hard to make that same
16 argument. So, you know, the two that are sort of
17 easy examples for us to bring to the table are
18 registered investment companies and ERISA
19 accounts.

20 And then on your second question, the
21 way that we would draw the distinction is looking
22 at the documentation itself. So what have the

1 parties agreed to? If you are a
2 separately-managed account, managed by investment
3 advisor A, and you enter into a swap with dealer
4 B. If dealer B has agreed I'm only going to look
5 to this pool of assets that are managed by advisor
6 A and that same account holder, that same
7 beneficial owner, has a separate swap with
8 investment advisor D, and that dealer is not
9 looking to the assets held in D, then why should
10 you have to aggregate those two swaps together?
11 That's the point.

12 MR. FAJFAR: And I think the -- so, the
13 concern is that -- now from the investor's
14 perspective, if I was wanting to take large --
15 just going to throw this out as a hypothetical. I
16 want to take large swap positions, I don't want to
17 be categorized as an MSP. So, I'll go to 10
18 different investment advisors, create 10 separate
19 accounts, have the accounts provide for at least
20 some -- so I can give some influence to how they
21 trade. Then, haven't you -- isn't that basically
22 a way to get around the MSP designation? I can

1 have each of those accounts make the same swap
2 trade, take the same swap positions. Why
3 shouldn't they be aggregated where I'm then
4 directing that activity?

5 MR. NEVINS: I definitely understand the
6 Commission's concern. As the Commissions have
7 stated in the proposed rule release, however, you
8 have anti-evasion authority and there are rules
9 that can be put in place that could prevent
10 anybody that's looking to manipulate the system,
11 either doing it as you suggest or otherwise, from
12 doing so and being subject to penalty from both
13 Commissions as they try to take advantage of the
14 system.

15 And in any case, if you do have an
16 account holder that segregates off and ring-fences
17 their pools of assets and the counterparty only
18 has access to that pool of assets, that's where
19 the exposure resides. That's where the risk is
20 created, and that's the way that our system -- you
21 know, our financial markets for asset managers that
22 advise these types of accounts work today. So,

1 where the parties have structured it that way, I
2 think that that should be respected.

3 I should caveat on that that isn't
4 always the case. So there are certain beneficial
5 owners that say, you know, we don't want to have
6 our assets at -- advisor A and advisor B
7 ring-fenced. We want them aggregated together and
8 where a client has chosen that, then we think that
9 it does make sense to aggregate it.

10 MR. KANS: May I -- to follow up on
11 that, does the answer change in terms of the
12 significance of ring-fencing your assets if the
13 purpose of the major participant definition is not
14 just to get to the counterparty risk but it's also
15 to get to the market moving risk?

16 That is, if I have my -- if a large
17 entity has assets in a segregated account so
18 there's no direct recourse, but because of market
19 movements the entity has to unwind its positions
20 in that account and other accounts, then even
21 though the direct credit exposure would not be
22 large with regard to any individual counterparty,

1 there still could be the potential for market
2 movements associated with the unwinding of those
3 positions. So, does the answer perhaps in part
4 depend on what we're trying to get at with this
5 definition?

6 MR. NEVINS: Again, a good point, Josh.
7 Good question. And it may. As I mentioned at the
8 outset, I do believe that the intent here is to
9 get at systemic risk.

10 That said, I do think where you have the
11 potential for a default and that default, again,
12 is ring-fenced with one particular manager under
13 one particular instrument and there is no
14 cross-default, if you will, into the separately
15 managed pool, that it doesn't make sense to put
16 those two different swap positions together.

17 MR. THUM: Could I perhaps probe the
18 question a little so that I understand it better?
19 So, day one, an entity is trading -- and let's
20 ignore the separate accounts at this point. But
21 is trading and has fully collateralized its
22 positions. And not only has fully collateralized

1 the market value of the positions, but also has
2 fully collateralized the volatility in the
3 positions that over a time period, appropriate for
4 the normal closeout of the trades. On day two,
5 the party desires to liquidate its positions. And
6 in that liquidation, owes money to the dealer with
7 which it's trading.

8 Now, if for some reason the party cannot
9 pay the dealer the value of the trades for some
10 reason that it wants to liquidate, the dealer is
11 holding market value collateral plus additional
12 collateral relating to volatility.

13 So, I'm trying to understand how in a
14 liquidation mode if the trades are fully
15 collateralized -- not only with respect to market
16 value, but also potential exposure -- how that
17 would raise to the level of being significantly
18 relevant with respect to the financial markets.

19 The other issue is that with respect to
20 the separate accounts, certainly with respect to
21 the accounts where there's a contractual
22 arrangement, the dealer has agreed up front that

1 this particular sleeve, that this particular asset
2 manager is managing is large enough with respect
3 to the credit lines that the dealer is giving to
4 do swaps and have recourse only to that limited
5 scope of assets.

6 Again, the trades will be put on. They
7 will be fully collateralized. If they are
8 registered funds, typically they will not be
9 posting independent amount, they'll be addressing
10 current exposure.

11 If you have five asset managers, each
12 managing an individual sleeve with recourse
13 limited to the assets under management by the
14 individual asset manager, it would seem to me that
15 the greatest exposure you're going to face relates
16 to the minimum transfer amount that the parties
17 have agreed, which is typically a de minimis
18 amount, such as \$250,000, which is an amount which
19 the parties say, up front it's too much trouble to
20 actually transfer collateral of \$5 if there's a
21 market movement of \$5 a day. We're going to wait
22 until collateral -- until the market position

1 moves \$10,000, \$100,000, \$250,000. But generally
2 in that range. So you could conceivably have five
3 aggregations of risk related to the minimum
4 transfer amount. Again, significantly lower than
5 the thresholds that you've established in your
6 rule.

7 So, I think that with respect to both
8 the separate accounts in those situations that
9 Matt had mentioned and then with respect to this
10 idea of liquidating positions, provided those
11 positions are fully collateralized and, indeed,
12 potential risk has been addressed by posting
13 independent amounts, I'm struggling to see how
14 there could be significant risks presented.

15 MR. KANS: Well, I -- please.

16 MR. STANLEY: There does seem to be an
17 argument here that funds already practice good
18 prudential and capital management practices, which
19 I have no reason to doubt. But we can see already
20 in the statute that even banks that are subject to
21 prudential standards are still required to
22 register as MSPs.

1 And the other question I'm wondering
2 about with this -- and Bill did start to get at
3 this with one of his previous answers is, if one
4 already practices good prudential standards that
5 are -- that I would assume are similar to the
6 prudential standards that one would have to follow
7 under the MSP designation, then how does the MSP
8 designation create an additional burden on the
9 funds beyond what they're already doing? I mean,
10 wouldn't the funds satisfy a lot of the
11 requirements under the MSP designation already,
12 based on these prudent practices that they already
13 follow?

14 MR. NEVINS: I'll start off, and
15 responding to that one. A couple things.

16 First of all, it's not just the
17 standards that you're going to be required to be
18 held to if you're an MSP. But you're also subject
19 to enhanced margin requirements and enhanced
20 capital requirements, which are costly and
21 burdensome for our fund shareholders. We're
22 talking about registered investment companies,

1 they're retail investors for the most part.
2 People that are saving for retirement, for college
3 education, and the like. And the burdens will
4 fall on them, to the extent that you have a fund
5 that could be.

6 You know, again, as I stated at the
7 outset, we are very supportive of the thresholds
8 that have been proposed and think that it's very
9 unlikely that any of our registered investment
10 companies could give rise to having to register.
11 The second part of my response to your question
12 would be that the standards that MSPs will be held
13 to are different than the standards -- we think --
14 that the Securities and Exchange Commission
15 requires of registered investment advisors, and
16 registered investment companies.

17 So, you wind up with duplicative
18 regulation that may, indeed, be inconsistent. So,
19 it puts more of a compliance burden on our
20 industry, again, which could result in greater
21 costs.

22 MR. THUM: I agree entirely with what

1 Matt said, and I think, you know, when we think
2 about risk mitigation techniques, the greatest one
3 present in our market today is the netting ability
4 under a master agreement. You do multiple trades
5 under a master agreement, you come up with one net
6 amount that is owed, at least within the United
7 States.

8 Posting collateral against that is the
9 next line of defense. And indeed, the present
10 market requires that. It's standard market
11 practice. And the third line of defense is the
12 type of entity that's trading. And investors
13 choosing to invest in registered funds are
14 investing in highly-regulated, very specialized
15 investment vehicles that have an enhanced level of
16 risk mitigation built into them.

17 The major swap participant category --
18 my understanding of it is simply to capture very
19 large users of swaps that are not -- do not meet
20 the dealer specification and present risks to the
21 system. It's not meant to be -- and I don't think
22 the Commissions probably have the resources to

1 handle registration of major swap participants
2 that could include entities like registered funds
3 that present a level of un-cleared,
4 uncollateralized swaps trading that is
5 de minimis.

6 I think the target and focus for an
7 efficient use of regulatory oversight is at the
8 largest users, and you have to look at the other
9 entities and see, do they have netting? Do they
10 clear their swaps? Do they have collateral
11 backing at their swaps? Do they have regulatory
12 oversight already in place that limits their swaps
13 trading? And if that's the case, then there
14 should be if not an exemption, certain safe
15 harbors that should apply to allow you to focus
16 where your focus is meant to be on those entities
17 that present the greatest risks.

18 MR. FAJFAR: I think -- just would like
19 to -- before we go too far down on this road, I'm
20 not -- I just want to put a couple other points
21 out on there.

22 The MSP definition, even -- we -- at the

1 -- at our meeting, there was the two handfuls
2 example. Even if it's five handfuls -- even if
3 we're talking about, you know, a number beyond --
4 we're talking about very few entities in
5 comparison to the entire market. I just want to
6 -- but my point really is, I understand, you know,
7 we have a question of who is on the panel.

8 I just want to point out we're talking
9 very heavily about how collateralization solves
10 the MSP problem, and it's really about
11 uncollateralized exposure. And I just want to
12 make sure that the staff is aware that that means
13 the -- which entities don't want to post
14 collateral. You can find out -- that's -- that
15 reasoning is leading to look at those entities
16 that aren't posting collateral as the MSPs. I
17 just want to put that out as an issue. And it
18 makes it very hard to -- it's just a difficulty in
19 doing the MSP definition.

20 I'd also like to just point out that
21 we're aware -- if you look at the categories, the
22 other commodity category in the PFE test has a

1 much higher haircut. So I just wanted to make
2 sure we put that 10 to 15 percent.

3 So I just want to be able to put that
4 out on the table, if anybody wants to comment,
5 that we're aware of that. That, you know, we get
6 in a discussion of whether registered investment
7 company is an MSP. That's an important discussion
8 but there are a lot of other swap users out there
9 that aren't registered investment companies that
10 don't post collateral.

11 And there's that issue, the elephant is
12 in the room.

13 MR. MASTERS: I would just say, also,
14 that I mean, sort of from a broader brush
15 perspective with regard to the intent of broad,
16 you know, Dodd-Frank. You know, systemic risk is
17 an important consideration. But you know, one of
18 the reasons we have Dodd-Frank is, we're putting
19 some regulation around a market that really didn't
20 have any regulation. And there's a lot to
21 business conduct with regard to this issue, and a
22 lot of the other issues.

1 And people like to say, well, it's just
2 systemic risk. And if I can just deal with that
3 issue, then I'm okay in everything else. And
4 that's not it. Or, not just it. I mean, it's
5 also business conduct. And it's all -- it's the
6 transparency from the regulatory process that we
7 get from the standpoint of the general public on
8 large institutions that we didn't get before that
9 we'd like to get today. I believe, you know, in
10 terms of the intent of the law.

11 MR. BERMAN: Can I just follow a
12 question on that, Michael? Is there an aspect --
13 again, if you look at all the rules of
14 transparency, comes through SDRs through SBSRs, so
15 there's other rules that apply. Business conduct
16 issues would be related to folks that deal with
17 customers, perhaps such as dealers. We have those
18 conversations.

19 Is there an aspect for a major swap
20 participant -- so, someone who is not one of those
21 other parties that is -- that you think can bring
22 risk to the table of a type that we have not

1 considered or is not already captured by other
2 rules?

3 MR. MASTERS: I think from -- I mean, I
4 think there certainly is from the perspective of
5 liquidity. In the sense of if you've got a large
6 enough entity that, given the right set of events,
7 you could have a -- I assume you're talking about
8 -- you know, from the standpoint of collateralized
9 or not collateralized or sort of that train of
10 thought. But there's other issues, in my view, in
11 this particular situation. I mean, the big one is
12 sort of liquidity. It's the idea that, you know,
13 someone that's large enough could be -- could have
14 pretty significant consequences on the market for,
15 you know, one day or, you know, whatever.

16 MR. BERMAN: Right. So to make sure I'm
17 clear, this would be a case of I'm fully
18 collateralized, I have more than enough money to
19 meet all my obligations, I wake up in the morning,
20 I just choose to liquidate. I'm retiring, so I
21 sell everything. I am so large that that selling
22 itself is disruptive to the market.

1 Not that -- I don't lose any money, my
2 counterparties don't lose any money. But what
3 you're saying is that it's just -- I'm so large
4 that I have the potential to be disruptive.

5 MR. MASTERS: Right. I mean the -- I
6 think an easy example to think about is a run on a
7 money market. You know, suddenly, you know,
8 someone worries about a particular fund or entity
9 or whatnot, and now we've got a run on a money
10 market. And everybody says, you know, I've got to
11 have my money now. And then that starts off a
12 cascade.

13 You know, it's -- you know, you could
14 say money markets are bad, you know, the Fed would
15 step in and, you know, but --

16 MR. BERMAN: Sure. No, that makes
17 sense. The reason why I wanted to go down that
18 line again was just to see if there were things
19 that are -- I think this aspect of major swap
20 participants is part of Title 7, is part of
21 derivatives. And perhaps some of the things that
22 you're talking about are covered in other sets of

1 rules. Title 1 has what we call SIFIs,
2 systemically important non-bank financial
3 institutions, that may address some of those
4 broader issues.

5 So, are there things that are specific
6 to swap users that are -- and the way that the
7 swap market works where you might have a player
8 that really isn't captured by any of those other
9 issues? But yet there's a risk that we are
10 missing.

11 MR. MASTERS: Well, I mean, let's say --
12 let's use commodities, for instance. Where
13 there's a situation where somebody has, you know,
14 \$10 billion total return swap on -- and suddenly
15 they have to unwind that. You know, let's say
16 it's a commodity index and, you know, 2 percent of
17 that \$10 billion notional amount is in the coffee
18 market, which is a pretty small market.

19 That has, you know, significant effects
20 on the coffee market. So, it's a derivative
21 transaction that's -- you know, there's an
22 underlying component to it that's now been, you

1 know -- someone asked on why. And it affects all
2 these other markets. And given the fact that
3 there's algorithms throughout the business now
4 that, you know, their modus operandi is to try to
5 push correlation, if you will.

6 If you do something in one market, it's
7 a derivatives market. Then suddenly, all these
8 other markets are affected because there's people
9 that have linked those markets together via
10 computer algorithms because, you know, typically
11 these markets were correlated. And suddenly this
12 market drops and now so this market drops and this
13 market drops and this market drops, and it sets
14 off a sort of a chain reaction. And so, that's
15 the idea of the systemic component.

16 MR. STANLEY: Yeah, I just wanted to
17 support what Mike was saying. We're looking to --
18 I think one difference between the Title 1 SIFI
19 definition is we're looking to the stability of
20 the entire U.S. and perhaps the world economy.
21 Here we could be looking to the stability of
22 particular derivatives markets.

1 But the other point I wanted to make is
2 that we're here discussing a designation rule, not
3 the requirements under that designation. I mean,
4 I think there are a lot of potential for
5 exemptions or safe harbors for particular
6 requirements for designated entities if they're
7 already doing good practices -- the kinds of
8 practices that we want to encourage.

9 But this is about designation as a major
10 swaps market participant, and I'm worried if we go
11 too far down the road of saying entities X, Y, and
12 Z are admittedly -- everyone admits are major
13 swaps market participants. But for whatever
14 reason, they're already safe, they're doing good
15 practices, they're well-managed, they're regulated
16 by somebody else. Then, we could really run into
17 a problem in terms of not designating some pretty
18 significant entities that perhaps in the future
19 might not be following those same management
20 practices.

21 And of course, we saw one of the
22 problems that Dodd-Frank is intended to address is

1 the shopping between different regulatory regimes.
2 And there's a lot of the belts and suspenders
3 stuff in Dodd-Frank that I think is aimed at that
4 kind of shopping between different regimes.

5 MR. KYLE: I'd like to mention a related
6 issue to what we're talking about. So, we've been
7 talking about -- have we missed any entities that
8 maybe should be labeled as MSPs? The question I
9 want to address is, how would you detect that if
10 you were?

11 And I think the answer goes back to
12 disclosure. And indeed, the key to everything
13 that we've been talking about today begins with
14 disclosure. So my way of thinking about the way
15 both the morning session and this afternoon's
16 session should work is that you start with the
17 idea that a derivatives contract is entered into,
18 and the simplest rule is to say that one party has
19 to be a swap dealer. And that swap dealer has an
20 obligation to report the transaction to -- in some
21 manner that the regulators, the CFTC and the SEC,
22 can add it up and understand it.

1 So under the OFR that's going to be set
2 up at the Treasury and, I think, here and at the
3 SEC, you've got various proposals taking place to
4 identify entities and also to identify the
5 instruments that the entities trade. So it's kind
6 of two sets of numerical or alphanumeric
7 identifiers -- unique identifiers that would allow
8 you to identify the players and then the positions
9 that they're holding.

10 It's going to turn out that that's not
11 enough. The discussion we've been having today
12 has indicated that you need some kind of notion of
13 a subsidiary or an affiliate that would be like an
14 additional identifier. And, you need some type of
15 notion of who the asset manager is and whether
16 he's managing multiple accounts in the same way.
17 So that's another set.

18 And I would add something else that's
19 probably going to happen. So, firms when they're
20 managing derivatives positions, they have the
21 value of the derivative contract itself. And then
22 kind of tacked onto that is the idea of credit

1 valuation adjustments, CVA. That's the change in
2 that value of that derivative due to the fact that
3 the counterparty might default. And then part of
4 that calculation is how much credit exposure do
5 you have to that counterparty to begin with. So,
6 it's kind of two things. How much credit exposure
7 and what's the probability of default?

8 There's probably a good case to have
9 that reported, too. And if that information is
10 reported along with the derivatives, then one way
11 to identify major swap market participants is to
12 look at the exposure that all the other players in
13 the market have to that entity and to look at how
14 much of a credit valuation adjustment they are
15 taking.

16 And in particular, if you ever reach a
17 circumstance where the counterparties to an entity
18 are taking billions of dollars in credit valuation
19 adjustments, then it's probably systemically
20 important and it probably should be considered a
21 major swap market participant. And that will be
22 one of the early warning devices that you would

1 get.

2 Now, I don't anticipate that the
3 reporting system is going to be efficient enough
4 to capture all the information that I just
5 mentioned within the next year or two. But with a
6 five-year horizon, I think it's feasible that it
7 could be that efficient.

8 MR. KANS: We certainly are mindful of
9 the data issues associated with the major
10 participant definition, as well as commenters who
11 have suggested that until we get more data, it's
12 premature to set the thresholds at a low level.

13 But before -- I would like a couple
14 minutes to move on to a couple more discrete
15 issues. But before we do that, Bill earlier, I
16 think, raised some very key and critical issues
17 that go to the heart of the matter. Which is, if
18 you do have collateralization, minimal exposure to
19 any time associated to, say, with the thresholds,
20 minimum transfer amounts -- does that address the
21 risks that really have to be addressed?

22 And Pete, since you're the professor, I

1 want to put you on the spot. In terms of, say,
2 what you're looking at from history -- the Hunt
3 brothers, LTCM, obviously the facts are different.
4 But if you are in a situation where you do have
5 daily mark to market margining, full
6 collateralization, no significant counterparty
7 risk at any time, does that address the sort of
8 market moving issues that you also alluded to? Or
9 are they really of a different type?

10 MR. KYLE: I don't think it addresses
11 the market moving issues because there's what
12 people will call potential exposure. But there's
13 what's going to happen or might happen in the
14 future that would be an adverse event that would
15 take an innocent-looking entity and then suddenly
16 turn it into a systemic nightmare.

17 AIG is an example. As long as those AAA
18 honchos are trading at par, you know, AIG is going
19 to claim that they're immaterial. Essentially,
20 risk free. But when they fell to 70 cents on \$1, you
21 have a major catastrophe in place. So, you can't
22 just say they're trading at par, therefore there's

1 no danger here.

2 And similarly, LTCM was exactly the same
3 type of situation. As long as their positions
4 were profitable and they seemed to be stable,
5 people would look at LTCM and say that it's
6 rock-solid. But then as soon as spreads started
7 widening throughout the market, people realized
8 that LTCM was headed for a disaster.

9 Similarly for the Hunt silver situation.
10 The Hunts were very well collateralized as long as
11 they could corner the market for silver, because
12 they had billions and billions of dollars. I
13 think it was \$7 billion worth of silver at \$40 or
14 \$50 an ounce. But when it fell to \$10 an ounce,
15 they essentially were bankrupt.

16 So, you can't just look at the current
17 situation and ask, are you well collateralized and
18 fully margined? You have to anticipate the bad
19 events which can happen in the future, which --
20 you can call it potential exposure or you can just
21 use your imagination.

22 The concept of potential exposure, the

1 way it's implemented by risk managers, has not
2 worked very well because the risk managers didn't
3 have enough imagination or enough pressure on them
4 to think about how bad the bad things that could
5 happen would be. And so, they missed a lot of the
6 credit risks associated with the mortgages and
7 paid a dear price for that.

8 MR. MASTERS: I just want to add one
9 point to that. I think what Pete's saying, you
10 know, in terms of the way I say it as sort of a
11 derivatives participant would be the concept of
12 short gamma. Which is that you know, you think
13 your risk is here but, suddenly, because of the
14 gamma embedded in the optionality of the contract,
15 it suddenly explodes. And you know, there's an
16 old saying -- it's one thing to be short, it's
17 another thing to be short gamma. Because the more
18 the price moves in one direction, the shorter you
19 get. I mean, your exposure goes up exponentially.

20 And so, one of the things that I talked
21 about in an earlier panel that I think is critical
22 on this subject, which really has to do more with

1 a reporting issue -- but is, again, when the swaps
2 are reported to an SDR, when they come from a
3 dealer, whoever, or the central counterparty of,
4 you know -- you know, a DCM or a SEF or what --
5 you know, any kind of reporting transaction, it's
6 really important to disaggregate those swaps into
7 component parts. And the reason it's really
8 important from a systemic standpoint to
9 disaggregate is to understand the concept of the
10 short gamma that's embedded in those transactions.

11 So when I talk about listed hedge
12 equivalents, then -- and then I say, listed hedge
13 equivalents adjusted for delta, then I've got a --
14 you know, what makes sense is understanding that
15 hedge adjusted for delta and understanding all the
16 Greeks that go with that derivative contract in
17 terms of the optionality of the contract. If
18 there's optionality built into it, only then am I
19 really going to understand the option and it's
20 embedded in the transaction or understand the
21 systemic consequences.

22 MR. FAJFAR: Could I just ask, would you

1 -- would that apply across the board? Or would
2 there be only some -- even if there's -- all swap
3 users? Or how would that requirement apply?

4 MR. MASTERS: I think you put it across
5 everyone. I mean, the other thing is, it's the
6 only language that we can all understand as
7 dealers. I mean, it's sort of like, you know,
8 we're all in a room and we all decide, you know,
9 we're going to speak Spanish for purposes of
10 derivatives. You know, we've all agreed to it.
11 And we already all speak this language. I mean,
12 dealers and customers already speak the language.
13 And when you do a swap with a dealer, they
14 immediately break down that swap into its
15 component parts.

16 And the desegregation into component
17 parts is really a key issue, because -- and it's
18 especially a key issue as it relates to systemic
19 risk. Because if you don't know the optionality
20 that's embedded in that swap contract, you really
21 don't know the risk of that swap. And by the way,
22 neither do other participants. And so knowing

1 that information does several things. It furthers
2 transparency to regulators, it furthers
3 transparency to the public. It also allows me as
4 a customer to evaluate various swap contracts on
5 an apples to apples basis, rather than you know,
6 not really knowing what they are.

7 MR. BERMAN: Mike, I think you make a
8 very good point about optionality and gamma. That
9 generally is a concern when folks are reporting
10 exposures as delta. But a potential future
11 exposure by design -- by definition, if it's done
12 correctly, is supposed to incorporate that. So
13 would there -- what would we change as opposed --
14 maybe just reemphasizing that?

15 By the way, when you do potential future
16 exposure, don't take the delta and multiply it out
17 by a volatility number. You actually have to do a
18 full-blown calculation.

19 MR. MASTERS: Yeah. I mean, if you're
20 -- you know, and again it goes to the point -- and
21 in other words, if you're doing a billion dollar
22 interest rate swap, what does that mean? I mean,

1 what's the hedge? Because the dealer knows the
2 hedge before he does the trade. I mean, he's
3 going to know that hedge. So, he has the
4 information. So we're asking the dealer to report
5 the information. And that there's optionality
6 embedded in that contract, then we're asking to
7 know the full Greeks. The delta, the theta, the
8 vega, and the gamma on that position. We need to
9 know all four of those from a reporting regime.

10 MR. BERMAN: But, who's the 'we'? And
11 what does it mean for the major swap participant?
12 I mean, is it the -- potential MSPs have to
13 calculate these, but that should be in the PFE
14 calculation. That is --

15 MR. MASTERS: Any significant swap
16 dealer is already calculating -- if they've got
17 optionality built into the swaps that they're
18 doing, they're already calculating the Greeks.

19 MR. BERMAN: Right. But what do we --
20 what are they supposed to do with that, and how
21 does that impact the MSP? Is that -- are you
22 suggesting there should be a test that we add that

1 includes those factors, or?

2 MR. MASTERS: I'm really talking about
3 best practices in terms of reporting. In terms of
4 -- you know, conduct. Any time a derivative
5 transaction is reported, it should be reported in
6 terms of its component parts and then the four
7 Greeks. Whether it's, you know, by any customer.

8 MR. KYLE: So, let me -- another
9 variation on that is --

10 MR. FAJFAR: Can I just -- I don't want
11 to put Bill and Matt on the spot, so you can say
12 no. But, does that sound right to you? Is that
13 what you would want your dealers to be doing? Is
14 that realistic?

15 MR. NEVINS: No. And I'm glad you
16 asked, so I'll just sort of jump in and say that
17 you know, from our perspective you've got to
18 balance two things here. You've got to balance
19 the need to gather information and test -- again,
20 those entities that are going to create risk, and
21 not making the tests overly complicated and
22 complex for people to apply.

1 So for all participants in the swap
2 space, you're going to have to be monitoring
3 without -- we've talked a bit about a safe harbor
4 or a filter here. But, without that. You've got
5 to monitor on a daily basis what your positions
6 are. And the more complex that we make the tests,
7 the harder it's going to be to do that. The more
8 onerous it will be on every participant, the more
9 compliance systems and build-outs and employees
10 we're going to need to actually do that analysis.

11 Now, I mean, to Mike's point. I mean,
12 dealers may be doing this today and hedge funds
13 may be doing that today, and some of our more
14 sophisticated employees are looking at this stuff,
15 you know, and thinking through their trading.
16 However, we're not doing compliance testing and
17 monitoring on that basis.

18 So one thing that, as I think I've
19 previously mentioned, you know, we very much
20 support the notion of keeping these tests simple.
21 We think that you've picked out the right factors
22 to apply when you're discounting notional amount,

1 looking at potential future exposure.

2 We still believe that the most important
3 factor is looking at uncollateralized exposure.
4 And if you believe that there is a necessity to
5 look at size as well overall counterparty
6 exposure, that does make sense to discount based
7 on risk weighting, to discount based on netting,
8 to discount based on clearing. And, to discount
9 based on mark to market margining.

10 And again, as I mentioned earlier, I
11 think that there's very good policy reasons to
12 encourage clearing and to get a full discount for
13 any swaps that are traded through a clearinghouse.

14 MR. THUM: I think as well -- I agree
15 with everything Matt said. I think as well, you
16 know, we really have to look. What are we trying
17 to hang our hat on here in this major swap
18 participant definition? And what other tools are
19 there in the arsenal in terms of transparency into
20 the market and mitigating risk?

21 And certainly we discussed in terms of
22 implementation of the derivatives portion of

1 Dodd-Frank overall that the -- kind of the crown
2 jewel, the first piece that needs to be
3 implemented is the swap data -- the SDR reporting.
4 And we think it's critical from a number of
5 reasons. One, of course, to provide the
6 regulators with transparency into the market --
7 into potential concentration issues, into all
8 sorts of things which the regulators have had
9 virtually no window into up until this point. And
10 we certainly support that.

11 Also, it allows the regulators to make
12 informed views on issues that perhaps are issues
13 that are occurring to folks at present, but rather
14 than address the issues in the absence of
15 information we feel that informed decisions should
16 be made based on the data as it comes in the door.
17 So we certainly support SDR reporting in every
18 way, but we don't feel that the major swap
19 participant definition needs to be the fix-all for
20 everything. And we think that it is appropriately
21 targeted at the right risks, and has the right
22 tests to achieve its objective.

1 MR. KYLE: So, I actually with what Mike
2 was saying earlier. And I think if you have a
3 bespoke derivative that you're trying to report to
4 the regulators -- and I agree that the regulators
5 need to understand what these derivatives are --
6 how do you report it? You can't send a 500 page
7 scanned legal document and send that for every
8 single derivatives contract and expect the
9 regulators to know what it means. So, it has to
10 be reported in some form that is understandable.

11 And the simplest form that would be
12 understandable would be to say, this bespoke
13 derivative is more or less equivalent to some
14 combination of other derivatives that are already
15 standard derivatives that everybody understands.
16 And if you report it that way, it captures the
17 various Greeks that you're trying to capture
18 automatically. And, it captures even more.

19 So, it seems to me to do reporting that
20 way makes a lot of sense. Now, what does this
21 have to do with MSP definition? If you have two
22 swap market participants and one of them has an

1 opaque book full of bespoke derivatives and the
2 other has an otherwise kind of similar book of
3 very liquid exchange-traded derivatives, which one
4 poses more systemic risk to the economy?

5 And I think the answer is, the book of
6 bespoke derivatives is going to be much riskier to
7 unwind because people may not understand exactly
8 what all these contracts are. There would be
9 difficulties associated with novating the
10 contracts over to somebody else if you needed to
11 swap from one counterparty to another. It would
12 take a long time to get good bids on these if
13 they're very complicated, so clearly the
14 derivatives participant who has a lot of bespoke
15 derivatives in his portfolio poses more risk than
16 one where it's all exchange traded.

17 So, it's kind of -- it would be helpful
18 to even relaxing the definition of an MSP to allow
19 the -- to have the reporting be as transparent as
20 possible so that these difficulties I'm talking
21 about would be minimized.

22 MR. MASTERS: Yeah, and just to be clear

1 -- to Matt's point. You know, it does have to do
2 with MSPs and what I was really, you know,
3 proposing was really when the trade is reported.
4 I wasn't really proposing an ongoing sort of, you
5 know, compliance thing of, you know -- the reality
6 is, most firms, you know -- many firms will do
7 this for their own stuff. I wasn't proposing that
8 as an ongoing thing.

9 But when the trade is reported. Because
10 then, at least you know the Greeks. And to what
11 Pete's saying is, you've got that. You know, if
12 you've got a billion dollar portfolio of bespoke
13 derivatives and you've got a billion dollar
14 portfolio of listed derivatives, then you can
15 actually compare the two. And that would be a lot
16 of use to regulators.

17 MR. NEVINS: So when we bring it back to
18 MSP, you know, it might be hard to believe this
19 but I think we're all kind of saying the same
20 thing.

21 So, you know, my view is that you got to
22 try and keep the test for the people that are

1 actually going to be doing the compliance
2 monitoring relatively simple. And I think that
3 what the Commissions have proposed in the rule
4 actually picks up what Pete and Mike, you guys,
5 are suggesting here. There is risk factor waiting
6 based on different types of swap instruments.
7 And, there is a discount for clearing swaps, which
8 are going to be more liquid.

9 Again, we would support a greater
10 discount for cleared swaps. But I think that the
11 distinctions are there. And I think that the
12 commissions have recognized that and have done it
13 in a way that tries to not overcomplicate it.

14 MR. STANLEY: But I think one thing that
15 both Pete and Mike were getting at is not just how
16 the test is calculated, but how the reporting
17 requirements and also -- the reporting
18 requirements to regulators and the reporting
19 requirement to customers under the business
20 conduct rules will change the way the market
21 works. Because this desegregation is going to
22 make it much easier, it's going to make prices

1 much more transparent to customers, and it's going
2 to make risks much more transparent to regulators.

3 And the designation of major swaps
4 participant is kind of the regulatory vehicle
5 through which these good things are going to
6 happen. Even apart from the prudential standards,
7 just the informational elements.

8 MR. NEVINS: So, can you elaborate a bit
9 on that? Because I'm not sure I understood that.
10 The transparent -- so, business conduct rules --
11 really that's associated with dealers, not the
12 major swap participants, necessarily, based on the
13 statute?

14 If you look at a lot of the reporting
15 rules, that's not under the MSP aspect. That's --
16 you have to report whether or not you're an MSP,
17 whether or not -- doesn't matter who you are, you
18 have to report. So, all of those things -- so I
19 think your statement was that the MSP is the
20 vehicle by which a lot of those good things
21 happen.

22 But I think a lot of those good things

1 happen no matter what. At least, I hope they do.

2 MR. STANLEY: Well, I'm reporting -- I
3 hope you're right. And I think that if the
4 reporting requirements are done well, I hope
5 you're right about that.

6 I think on the business conduct
7 standards, in the statute, at least, business
8 conduct standards are applied to both dealers and
9 major swap participants. And I don't think we can
10 assume -- I mean, the dealer and major swap
11 participant distinction, it's a very interesting
12 one. Because the dealer definition doesn't really
13 have to do with size. It has to do with your
14 relationship with your customer in a particular
15 kind of way.

16 And then we have this other definition
17 that's based more on size. And I think if you
18 make a whole bunch of business conduct standards
19 only apply to dealers, then people may find
20 creative ways of being big but not dealing with
21 their customers in a way that brings them under
22 the dealer definition and start to migrate over

1 there.

2 MR. BERMAN: That's a very good point.
3 Point well taken.

4 MR. NEVINS: If I just for one moment
5 just -- can just add on to what you're saying,
6 Gregg, because I think it's an important point that
7 the Commissions are both putting out a whole host
8 of rules that will apply to all swap participants,
9 not just to MSPs and dealers. There's obviously
10 enhanced requirements in certain areas for MSPs,
11 but you know, I think a lot of the concerns in the
12 swaps markets in general are being picked up
13 elsewhere. So I think that's an important point
14 for folks to recognize.

15 MR. KYLE: So, let me -- can I make sure
16 I understand? Because if I didn't, I want to make
17 a point.

18 So I think if it were to happen the way
19 I would like for it to happen, every derivatives
20 transaction would have a dealer as one of the two
21 parties. But if it doesn't happen that way and
22 you imagine that some transactions don't have a

1 dealer but they have a major swap participant
2 trading on one side and then a -- let's call it a
3 minor swap participant -- trading on the other
4 side, then the major swap participants would be
5 subject to some business conduct standards that
6 would otherwise be applicable to dealers on that
7 subset of transactions.

8 And if that's the case, then I 100
9 percent agree with what Marcus was saying.

10 MR. KANS: Okay, I'd like to move on to
11 a couple more discreet issues. First is, as was
12 alluded to earlier, there has been a suggestion
13 for a calculation safe harbor for entities that
14 are significantly below the thresholds.
15 Basically, a statement and relief from the threat
16 of enforcement action that they would not have to
17 undergo the calculations needed to determine
18 whether or not they are a major participant.

19 I'd like people to address the why
20 behind that because if one is significantly below
21 the thresholds, then what would be the driving
22 force behind even having to go through the

1 calculations if you're already pretty confident
2 that you would never be a major participant under
3 the tests?

4 MR. NEVINS: Okay, sure. I'll go first
5 on this one.

6 So, the idea is that as careful
7 participants in the financial marketplace that are
8 subject to regulation under your purview, we want
9 to make sure that we're not running afoul. And we
10 have duties to our clients to make sure that we
11 are actually monitoring what we're required to do.

12 So, you know, the release does say that
13 the intention of the Commissions is that if you're
14 far enough below -- and I'm paraphrasing. But if
15 you're far enough below the thresholds, that you
16 wouldn't have the burden that's related to
17 actually doing that daily monitoring. But you're
18 required in order to do this test, and to test --
19 to measure the test -- to look at your positions
20 on a daily basis.

21 So, the theory behind this is that if
22 you test, let's say, monthly or you're looking at

1 monthly numbers or quarterly numbers and you're so
2 far below the thresholds -- let's say you're 50
3 percent below every single threshold for current
4 exposure and potential exposure determined at the
5 end of the quarter or at the end of the month.
6 Then it could save a lot of unnecessary work and a
7 lot of unnecessary compliance obligations to have
8 that regulatory certainty that we're not going to
9 get in trouble because we weren't following every
10 day where our positions are.

11 So, that's the idea. The notion here is
12 that it will save us cost, it will save us
13 manpower where we're so far below the proposed
14 thresholds. Again, an example would be 50 percent
15 below every test, then instead of following it on
16 a daily basis you follow it on a monthly basis.
17 On one day a month you do your test. If you're
18 below 50 percent of all the thresholds, then you
19 move on to the next month.

20 MR. THUM: Yeah, I think that's exactly
21 right, Matt. And you know, our aim is not to
22 avoid responsibilities. Our aim is simply to

1 clarify what those responsibilities are. And I
2 think particularly when you have a test that's
3 based on average daily numbers over a particular
4 period -- the reason for that is to recognize that
5 you could have spikes and you could have peaks and
6 troughs within that particular period.

7 It does, indeed, suggest that you would
8 need to run the test on a regular basis if not a
9 daily basis. So, we of course have run the tests
10 on individual funds. Our funds use derivatives in
11 a minimal way. What we have found is the numbers
12 really reflect risk largely about equivalent to
13 the minimum transfer amount that we've agreed with
14 our dealers.

15 Of course, it's more complex than that
16 because you have to look at it within major swap
17 categories -- the six major swap categories, and
18 you have to do the PFE calculation on the nine
19 different convergent factors, depending on the
20 trade type and the maturity of the trade. It's a
21 very complicated test.

22 So, we agree that you know, perhaps you

1 could have a gross notional test. Or if the gross
2 notional amounts that you're trading are below the
3 thresholds, then you would simply not need to
4 calculate the test at all. And only if you met
5 the gross notional test would you calculate it
6 monthly, until you reached the 50 percent level
7 that Matt suggested. Once you reach the 50
8 percent level of these multi-billion dollar
9 thresholds, would you then start to calculate
10 daily.

11 So I think it would help us, certainly,
12 to have a clarified -- that given it is an average
13 daily volume within this particular period, that
14 we simply would have a way to assess that, indeed,
15 we don't need to do the test. Although we could
16 do it periodically, on the basis that I just said.

17 MR. STANLEY: It seems like a gross
18 notional test makes some sense in the sense that
19 the exposure -- your exposure test would be a
20 subset of gross notional, right? So that if you
21 met a gross notional test, you'd be guaranteed
22 that you would make the other test. But in terms

1 of calculating on one day a month or something
2 like that, that seems potentially a little bit
3 tricky or a little bit easier to game than
4 something like just a gross notional test, which
5 people should be aware of pretty easily, right?

6 MR. NEVINS: So, the suggestion that I'd
7 put out is just that, a suggestion. And Marcus,
8 you know, we wouldn't be opposed to using gross
9 notional as opposed to, you know, 50 percent -- a
10 50 percent threshold of where you fall against all
11 the tests in the rule proposal. So, there are
12 lots of different ways of doing this. And you
13 know, I think that one certainly could look at
14 gross notional as a standard for when you are
15 actually required to do the calculations.

16 MR. THUM: Yes. And if I wasn't clear,
17 I mean the gross notional would just be a window
18 in to allow you to start to do it on a monthly
19 basis. And if you've done it on a monthly basis
20 and you exceed the 50 percent level of the
21 threshold itself at any given month end, then you
22 would do it every day. So, there'd be kind of an

1 escalating responsibility.

2 But again, you know, certainly from the
3 registered funds perspective the numbers are going
4 to be very small.

5 MR. KANS: I would like to turn to one
6 final issue, then for this panel. The definition
7 of hedging and mitigating commercial risk. This
8 is a definition that's parallel to the end user
9 clearing exception, also.

10 Commenters addressed and critiqued a
11 number of aspects. The economically appropriate
12 standard that was proposed, including language on
13 the SEC side about additional new types and quanta
14 of risk.

15 The carve-out -- the exclusion -- from
16 the exclusion for positions that are speculative
17 and trading in nature, including language of these
18 include positions that that themselves hedge
19 speculative and trading positions, as well as on
20 the SEC side the procedural aspects.

21 So, I'd like people to -- ideally
22 starting with the economically appropriate

1 standard -- address these issues, please.

2 MR. KYLE: I don't think it's possible
3 to make a meaningful distinction between a hedging
4 transaction and a speculation transaction. That's
5 implement-able. And I don't think it's very easy
6 to make a distinction between a commercial
7 transaction and a non-commercial transaction.

8 But there is one type of transaction
9 that's fairly -- where the distinction is fairly
10 easy to make. And that is, if you enter into a
11 contract to buy a commodity from the person who
12 produces it and the person delivers you that
13 commodity under the contract, then it's not really
14 a derivative. It's a physical commodity
15 transaction.

16 And similarly, if you sell a commodity
17 to someone -- if you sell soybeans to a facility
18 that crushes those soybeans and you deliver those
19 soybeans to that facility and they, you know,
20 crush them, then it's not a derivative contract.
21 It's just a physical transaction in the commodity
22 itself. That should be the basis for the

1 exemption.

2 So, the basis for the exemption should
3 be that it is a transaction and a commodity that
4 end users are producing and consuming on one side
5 of the transaction or on the other. Even though
6 one part of the transaction could be a
7 merchandiser. I think all the other distinctions
8 are going to simply result in loopholes and
9 regulatory burdens and costs.

10 MR. MASTERS: Yeah, I would just -- I
11 would sort of echo that.

12 I mean, the sense of the capital
13 markets, specifically, you know, with regard to
14 the SEC. I mean, it's easy with the commodity
15 markets where you've got hedgers
16 and you've got speculators. And there are
17 some clear delineations.

18 But, you know, with regard to the
19 capital markets. I mean, pretty much everybody in
20 there is a speculator, if you will, or an
21 investor. And so more representing in the sense
22 of a fund or whatnot.

1 So, it's -- so in terms of hedging, you
2 know, what are you really hedging? I mean, you're
3 hedging your interest rate risk. Well, your job
4 is to take risk, and you can take down risk or
5 take up risk. But I mean, you're there as a risk
6 taker. I mean, that's your function in the
7 capital markets as a participant. And so, I think
8 it's sort of tricky.

9 But just to go a little further in terms
10 of, you know, economically effective hedges. I
11 think there's a couple things that you'd want to
12 avoid in terms of highlighting. You know, one
13 would be the idea of a swap that would have a
14 greater duration than the commercial risk. For
15 instance, if a swap -- if -- and this would go
16 back to the commodity -- if you were to be
17 delivered wheat in December to use in your mill,
18 and you had a contract for six months later than
19 that, then that six month period of time now is a
20 -- is not a hedge in the sense of -- you're making
21 a bet out in time that you don't need that
22 represents your commercial interests.

1 Another thing that I would add on to
2 that would be -- that's actually mentioned in the
3 statute that I just pointed out. Would be a hedge
4 on a hedge. You know, you've got a hedge on a
5 hedge, and so one of the things that was sort of
6 thrown out there was, okay. So I'm doing a swap
7 contract with a counterparty. And then I buy a
8 CDS contract on that counterparty to hedge the
9 counterparty. So, that's a hedge on a hedge, in
10 my view. And that would be something that
11 shouldn't be considered as part of the hedge.

12 And I would also say that given the fact
13 that end users can require that a swap dealer does
14 the trade on a DCM or centrally-cleared place,
15 then there's probably no need for that anyway. If
16 I had the option to make a swap dealer clear a
17 trade on a DCM, then what's the point of having
18 CDS protection on them all? It sort of obviates
19 the need for CDS. So, at any rate.

20 So those are sort of the points I'd make
21 on that.

22 MR. NEVINS: So, a couple things. First

1 of all, we could probably have a panel that would
2 maybe last all day on the definition of hedging as
3 it applies broadly throughout the rule sets here.
4 Let's not do that.

5 We have a few minutes left here today,
6 so instead let's focus on this rule itself. And
7 the statutory language includes the phrase
8 "hedging or mitigating commercial risk". So to
9 me, for this MSP discussion, you've got to look
10 more broadly than -- even if you took a narrow
11 view of hedging where you actually have to hold
12 the underlying in order to be deemed to be hedging,
13 you've got this piece about mitigating commercial
14 risk as well.

15 To the particular question on what's
16 economically appropriate -- and, you know, we know
17 that there is some differences in the proposal
18 between the CFTC and the SEC here on how you
19 define hedging or mitigating commercial risk for
20 this rule proposal. You know, one thing that
21 gives me some pause -- and Josh, you had mentioned
22 this during your question -- is that the swap

1 should not introduce any new material quantum of
2 risks.

3 And the trouble there -- and that, I
4 believe, is not part of the CFTC proposal. But
5 the trouble there and the concern that we have
6 there is that what if you have a proxy hedge? So
7 basically, you've got a hedge in place that -- or,
8 you have a swap in place that hedges out 80
9 percent of your risk but there may be some
10 additional, non-hedging piece to that swap. Do
11 you lose completely the credit of that swap from,
12 you know, taking it out of the analysis because
13 it's primarily being used to hedge?

14 Sometimes, you don't have a perfect
15 match, whether it's -- you know, in tenor or in
16 what's covered under the swap. You're using it to
17 hedge, but it doesn't match up perfectly with the
18 underlying. And we think a less restrictive
19 standard for applying the hedge or mitigating
20 commercial risk standard for this rule would be
21 appropriate.

22 MR. OPPENHEIMER: Can we move on a

1 little bit if you've covered that topic to the
2 notion of hedging -- swaps that hedge trading or
3 speculative positions? And I'll really talk
4 exclusively from the physical commodity side.

5 And the working group, together with the
6 Commodity Markets Council, put in a comment letter
7 on this about a week and a half ago. So, you can
8 take a look at it if you haven't seen it.

9 The notion of being able to count a swap
10 that hedges an underlying trading or speculative
11 position in the physical commodity markets is a
12 very, very important question. It's important for
13 the MSP definition. It's significantly more
14 important for the end user exception provision.

15 And I'm going to elaborate a little bit.
16 I think some of this is really self-evident, but
17 I'd feel like I didn't use my hour and a half of
18 sitting quietly without speaking a little bit now.

19 You know, trading in the commodity sense
20 is very, very different from trading in the
21 securities sense -- in the notion that you don't
22 just plop yourself down and open an account and

1 start trading paper. In order to trade in
2 physical commodities, you have to have quite a bit
3 of infrastructure. You have to have the ability
4 to charter ships, arrange transportation on
5 pipelines or on transmission lines. You have to
6 be able to deal with inspectors of product, you
7 have to be able to manage logistics associated
8 with getting ships into harbors. You need to have
9 customs relationships and ability to deal with
10 customs for imports and exports. It's a very,
11 very different business.

12 And it's long been known in the
13 commodities trade and recognized in commodities
14 regulation that there is a whole commercial
15 marketing chain running from producer, processor,
16 merchandiser, to end user. And that the
17 merchandiser, the trader plays a significant role
18 in the successful delivery of commodities from the
19 production to the end use.

20 And the reason for that is, of course,
21 you know producers don't all contract with end
22 users. And you don't have all production

1 committed to long-term contracts where it moves
2 from the production to the end use. And there
3 again, there's a very good reason for that. You
4 wouldn't be able to react to market conditions, to
5 hurricanes, to pipeline outages, to heat waves and
6 greater demand in particular locations if
7 everything was committed to long-term contracts.

8 So, you have merchants in the middle.
9 And they move product from place to place. And
10 whether that's done by a trading company that's
11 known as a trading company or whether it's done by
12 an integrated major, it's done by quite a few
13 kinds of companies in the energy and the
14 agricultural space, right? And that's the trading
15 activity.

16 So, when a trading company owns a
17 commodity, it has price risk. And when it hedges
18 that price risk, hedging that price risk with a
19 swap should be deemed to be hedging or mitigating
20 commercial risk for the purpose of the MSP
21 definition, and for the purpose of the end user
22 exception definition.

1 And frankly, I can't think of any policy
2 reason -- trying to put myself in your seats -- as
3 to why that shouldn't be the case. It has always
4 been the case. Ironically, it would -- that hedge
5 would be a bona fide hedge for a physical
6 commodity market player under the speculative
7 position limit regime. And it would seem
8 extremely odd to me if it would be pulled out from
9 that for the purposes of mitigating -- hedging or
10 mitigating commercial risk.

11 MR. FAJFAR: Can I ask a question, Ron?

12 MR. OPPENHEIMER: Yeah, sure.

13 MR. FAJFAR: So what -- then for a
14 commercial firm that's doing everything -- what
15 you just said. Really, then, in the normal course
16 or in any course, all other -- almost all other
17 swaps would be hedges. What would not -- is it --
18 what would not qualify -- or is that -- is that
19 the point?

20 MR. OPPENHEIMER: No. I mean, any one
21 of those firms might speculate as well.

22 MR. FAJFAR: What's the difference

1 between trading and speculation?

2 MR. OPPENHEIMER: I'm sorry. When we're
3 talking about trading here, we're talking about
4 trading the physical commodity. Right? So, the
5 swaps that hedge that activity would be swaps
6 hedging trading activity. And from my
7 perspective, would be swaps that constitute
8 hedging or mitigating commercial risk.

9 I thought you had asked me if they also
10 engaged in other swap activity, which isn't
11 hedging. And the answer is, they could. They
12 could engage in speculative swap activity. And
13 I'm not suggesting that they should be able to
14 deduct their speculative swap activity when doing
15 their exposure tests, or claim the end user
16 exception for speculative swap activity. But I am
17 saying that any swap that hedges a trading
18 position, or even a speculative position in a
19 physical commodity, should count as hedging or
20 mitigating commercial risk for these purposes.

21 And when I say a speculative position in
22 a physical commodity, there are times where a firm

1 might buy natural gas, put it in storage, perhaps
2 in the summertime in anticipation of a winter
3 heating season. And somebody might characterize
4 that as a speculative position. I don't know if
5 it is or it isn't, but you might characterize it
6 that way. The hedge of the price risk that that
7 party holds while it does that, before it delivers
8 that gas to an LDC or whatever, should constitute
9 hedging or mitigating commercial risk. Because
10 that's in the commercial supply chain, and the
11 party has price risk while it holds the commodity.

12 MR. FAJFAR: So just -- so once you make
13 the determination that the swap is a hedge and
14 it's hedge-related to a -- the supply chain
15 point, then you stop? That's your point,
16 basically?

17 MR. OPPENHEIMER: That would constitute
18 hedging or mitigating commercial risk, for both
19 the MSP and the end user exception.

20 MR. BERMAN: Can I ask a question, just
21 of how one might generalize that and what the
22 implications would be, depending on the

1 generalization?

2 So if what you're saying is that there
3 are firms -- merchant firms -- who, one can view
4 the physicals out there holding as speculative
5 positions. And what you're saying is that a hedge
6 on that is still a hedge, and therefore it should
7 be considered a hedge as opposed to a speculative
8 position?

9 MR. OPPENHEIMER: I am. I mean, my
10 point, I think, goes more to trading positions.
11 But I do believe that it -- and I'm certain -- it
12 -- you could characterize some positions as
13 speculative positions. And my point would apply
14 equally to that.

15 And it's different. Speculation has
16 this, you know, connotation to it. And so you
17 know, I just think it's very important to point
18 out that somebody who owns natural gas in a
19 storage facility for future delivery on to an LDC
20 or other user is very different than somebody who
21 buys a security or some other investment vehicle
22 for the purpose of earning a profit. You have to

1 truly be in the business of owning physical
2 commodities and transporting physical commodities
3 in order to buy something in the hope that the
4 price is going to go up.

5 MR. BERMAN: So if I set up a fund and
6 basically I speculate on gold, but instead of
7 buying gold futures I buy gold -- I have a vault
8 and I purchase that. Would you be able to
9 distinguish that activity from the activity that
10 you're talking about? Or would you say that those
11 are the same?

12 If you own the physical -- so, I own the
13 gold strictly because I would like to play the
14 gold market. But when I get nervous about it,
15 sometimes I put swaps on the other direction,
16 instead of selling the gold because I find it
17 cheaper. Did I -- do I get myself into a
18 situation where the gold physical hedges the swap
19 and the swap hedges the gold, therefore I actually
20 have no positions?

21 So, how do we not fall into that trap?

22 MR. OPPENHEIMER: Yeah. I mean, I think

1 in that example the gold fund is not a producer,
2 processor, merchandiser, or end user. So I think
3 you may be able to find a distinction in there.

4 MR. BERMAN: Okay. So you would be
5 saying that in the course of their regular
6 business, they are dealing with the commodities
7 for -- at some level, non-speculative purposes.
8 They're part of a supply chain, they're part of
9 some process. But is that sort of how you make a
10 decision?

11 MR. OPPENHEIMER: I think that's a fair
12 distinction.

13 MR. KYLE: So, what I see as the problem
14 -- I kind of would like to agree with what you
15 said. But what I see as the problem there is that
16 if I am a pure speculator in various types of
17 commodity derivatives and I want to pretend that
18 I'm not, all I have to do is buy a firm that's
19 engaged in lining up ocean freight and doing a
20 little storage and doing a little of this and that
21 that allows me to qualify as a commercial
22 operation. And then that commercial operation

1 becomes a cover for engaging in all kinds of
2 speculative behavior.

3 And that's what you'll see, right?
4 You're going to see hedge funds buying, you know,
5 like commodity operations and kind of pretending
6 to be engaged in the physical business if they
7 would otherwise fall under the major swap
8 participant definition and can use that as a way
9 of getting out from under it.

10 MR. OPPENHEIMER: I don't think so. I
11 mean, if you bought yourself a small little
12 physical operation and you were engaging in
13 trading that bore no relationship to that trading,
14 then I don't see how in any respect you could
15 claim that that operation turned your speculative
16 swaps into hedging that commercial operation. But
17 if you own that commercial operation and that
18 operation has discrete positions that it hedges,
19 certainly those would constitute hedging or
20 mitigating commercial risk.

21 I don't see how divorced operations --
22 just the existence of a commercial operation could

1 provide cover for a speculative trading shop.

2 MR. KYLE: So you don't think that coal
3 market transactions can hedge electricity
4 transactions?

5 MR. OPPENHEIMER: No, I don't.

6 MR. KYLE: So if I buy a little coal
7 mine, does that enable me to engage in electricity
8 speculation as a cover?

9 MR. OPPENHEIMER: No, but it would allow
10 you to hedge your coal prices -- I don't think
11 you'd hedge your coal prices with electricity.
12 But if you wanted to do that, I think if you had a
13 certain amount of expected production in the mine
14 and you wanted to hedge that with electricity
15 futures or electricity swaps, you could. But you
16 couldn't run a portfolio over here that bore no
17 relationship in size or relationship to what was
18 happening with the mine.

19 MR. STANLEY: I think this discussion
20 points to the importance of tying the hedge very
21 tightly and directly to the commercial exposure.
22 And the various requirements that are going to

1 have to be used to do that.

2 And we were concerned that the
3 economically appropriate language in the
4 regulation was too broad and vague. And there
5 wasn't the detail to line up the hedge with the
6 commercial exposure so that you could do what Ron
7 is saying. You could see whether the exposure in
8 the derivatives markets bears a real relationship
9 in terms of timing, in terms of size, in terms of
10 correlation with the exact commercial exposure
11 that was being claimed. And that's what the hedge
12 accounting rules make you do.

13 And we believe -- I know Better Markets
14 has said this several times in its comments --
15 that you should have a hedging strategy at the
16 company level that's approved at the board of
17 directors level that lays out what your commercial
18 exposures are, how that relates to the hedging
19 practices you're going to do, and then the
20 specific hedges should slot in under that
21 strategy.

22 And I just -- I also wanted to point

1 out, I was going through your -- the CFTC website,
2 actually. And I found a communication with SIFMA
3 where it was stated that SIFMA members believe
4 that the commercial exclusion should not be so
5 broad that it permits corporate end users of swaps
6 to accumulate very large positions without
7 becoming MSPs. And so, possibly for the first
8 time ever Americans for Financial Reform gets to
9 agree with SIFMA. And I think that when that
10 happens, the regulators should pay attention.

11 And what's going on here, of course, is
12 that SIFMA has a lot of members who are
13 speculators. And they recognize that if this
14 commercial exemption could easily become so broad,
15 that they would have to compete with entities that
16 claim to commercial end use exemption but were
17 actually speculating and competing with them. And
18 they don't want to have that competition, and we
19 don't want to see that happen, either.

20 And I think the way to avoid that
21 happening is to really be able to go into a
22 company and require them to have a clear hedge

1 strategy that's tied to commercial exposures and
2 does not, for example, reward traders based on
3 speculative profits from transactions. But
4 instead, really ties those transactions to
5 commercial hedging.

6 MR. FAJFAR: I just want to go through
7 it again with Ron, just to repeat since, you know,
8 it's the end of the day.

9 So, we take your situation company
10 involved in the trading stream. I think what
11 you're saying, this is not our -- what your
12 position is, that if you look at the swap. If the
13 swap is hedging, we know -- and it does meet the
14 definition of hedging -- and it's hedging a
15 position that's held for purposes of trading or
16 speculation, that's okay. It's not included in
17 the MSP test.

18 If the swap itself is a speculative
19 position, then it doesn't -- then you stop. It
20 doesn't -- how you're -- then it would go into the
21 MSP test. That's basically right.

22 MR. OPPENHEIMER: That's right. Then

1 it's a spike in a position, it's not -- excuse me
2 -- hedging a mitigating commercial risk. The
3 exposure would be added to the MSP definition.
4 You wouldn't be entitled to claim the end user
5 exception for that.

6 MR. FAJFAR: But you were just
7 addressing the point that once -- if you make the
8 determinate it's hedging -- the swap is hedging --
9 it doesn't matter what it's hedging. That's
10 really your point.

11 MR. OPPENHEIMER: And again, I'm not
12 addressing anything other than physical
13 commodities. And the answer is correct. If it's
14 a physical commodity transaction, hedging or
15 mitigating commercial risk -- and I'll leave aside
16 the gold example for the moment, too. A swap
17 hedging that physical commodity transaction would
18 be deemed hedging or mitigating commercial risk
19 for the purposes of the two definitions.

20 MR. KANS: And just to follow up on your
21 point about limiting your comment to physical
22 commodities. Understand that that's where you're

1 coming from and who you're representing. Do you
2 have views, though, as to whether or not the same
3 principles would apply to the financial swaps, the
4 securities-based swaps? Would the same underlying
5 principles apply and the same policy issues apply,
6 or would they be different there?

7 MR. OPPENHEIMER: I really don't have
8 the expertise on the security-based side to offer
9 anything on that.

10 MR. NEVINS: I'd answer yes. That I
11 think that the same principle should apply to
12 securities-based swaps as well.

13 And again, for the purposes of this
14 rulemaking, it includes mitigating commercial risk
15 in addition to hedging. And I think once you've
16 established that that's what you're using your
17 swap for -- for risk mitigation, for hedging --
18 then it's not included as part of the testing.
19 That would be our position.

20 MR. KYLE: So, a long-short equity beta
21 neutral, market neutral hedge fund is a commercial
22 hedger. And LTCM was a commercial hedger. And

1 therefore, get an exemption from major swap
2 participants?

3 MR. NEVINS: It's not an exemption from
4 MSP. It's part of the rule that when you test
5 substantial position, you back out swaps that are
6 used for hedging or risk mitigation. That came
7 from Congress, it's part of the statute.

8 MR. KYLE: Right. So, Congress has
9 exempted zero beta hedge funds that structure
10 their positions as swaps.

11 MR. NEVINS: They've exempted swaps that
12 are being used for risk mitigation or hedging,
13 correct.

14 MR. KYLE: So, LTCM has been exempted as
15 well, to the extent they use swaps as opposed to
16 physical --

17 MR. FAJFAR: The question --

18 MR. KYLE: I mean, I agree there's an
19 issue in whether the statute makes sense. And
20 that was kind of the point I was making earlier.
21 I don't see how this can of worms can be resolved
22 in any reasonable way. It's economics.

1 MR. FAJFAR: I just want to restate the
2 question in a different way. The point of the
3 question is, when they wrote hedging or mitigating
4 commercial risk, they meant to include the zero
5 beta hedge fund. That was the commercial risk
6 that was in mind when they wrote the hedging
7 exemption. I think that's the question, right?

8 MR. NEVINS: I won't speak to the
9 specific example, but I can tell you that I think
10 what they had in mind was that if you're using a
11 swap to manage your risk or to hedge, as opposed
12 to speculate and take a position on whatever the
13 underlying is, that those swap positions should
14 not be included in the calculation of the
15 thresholds.

16 MR. FAJFAR: I just want to give you the
17 chance -- when you said to manage or to hedge your
18 risk, you didn't say commercial. Your position
19 is, this is a commercial risk?

20 MR. NEVINS: Yes, Mark.

21 MR. MASTERS: I would just say -- I
22 mean, you know, in terms of -- I think, you know,

1 as I said on an earlier panel, you know, being a
2 hedge fund manager, there's nothing in my
3 portfolio I can't claim to be hedging a risk.
4 There's nothing. There's not a trade I do ever
5 that I can't claim it to be a hedge against
6 interest rates, or inflation, or against equity.
7 You know, the fact of the matter is, if you're a
8 capital market participant, your business is
9 taking risks.

10 Contrast that with a -- someone that's
11 taking commercial risk in an enterprise that's
12 trying to reduce risk. I should say, their risk
13 is their business. They're trying to reduce their
14 price risk. And in my opinion, Congress was
15 really focused on the commercial risk point, not
16 -- in the sense of the -- you know, the farmer
17 trying to hedge his wheat or, you know, the
18 classic examples that people think about.

19 But, you know, not some hedge fund
20 that's trying to, you know, hedge off a certain
21 kind of inflation risk by, you know -- or credit
22 risk. I just -- I don't think -- I think if those

1 were the only risks out there, we wouldn't have
2 the distinction, in my view.

3 MR. THUM: I think it probably would be
4 helpful for the Commissions to reach out to the
5 hedge fund industry on this question and talk to
6 them about that. You have two large asset
7 managers here that are focused on registered funds
8 and have very limited swaps trading. It's very
9 prudent and well-regulated. So, I think that the
10 question is probably worth getting to the bottom
11 to and probably is worth engaging directly with
12 the entities that you're talking about.

13 MR. STANLEY: I feel like you could
14 probably predict what a lot of those entities
15 would say. I just wanted to say, we agree with
16 the position that the Commissions took that
17 hedging and mitigating are synonymous in
18 Dodd-Frank, and that they are used synonymously in
19 many parts of the legislation. So, we would agree
20 with that.

21 MR. BERMAN: I know it's late so I'll
22 keep my question brief. I do think things turn on

1 the word "commercial".

2 So this is really a question for you,
3 Ron. If you were looking at one of these firms
4 that was moving physical commodities, engaging in
5 swaps, would you be able to distinguish in looking
6 at that firm saying, why do you own these things?
7 This does not seem to be part of a commercial
8 business.

9 And I say, actually -- we're taking a
10 bet over there. Yeah, you're right. We have no
11 clients, we have -- there's nothing going on here
12 that we're part of a pipeline. That's -- we have
13 our own bet going on.

14 Is that distinction meaningful? Because
15 we're asking about it from the hedge fund
16 standpoint. But I'd first like to see even within
17 the physical commodities. Is that a meaningful
18 distinction?

19 MR. OPPENHEIMER: If I understand it,
20 no. So, you're suggesting that somebody owns a
21 physical commodity like natural gas, like oil, and
22 they're not looking to market that to an end user

1 or pass it along in a marketing chain? They just
2 want to hold it and leave it aside for a while and
3 see what happens to the price?

4 MR. BERMAN: So I'm -- maybe I
5 shouldn't' have used my gold example. I use an
6 oil example. I buy oil. I stock it up in my
7 house, and then I hedge it and then I sell it back
8 and forth. It's purely for profit, I have no
9 clients, et cetera.

10 I join one of the energy firms, and I --
11 and they say, so what's your business? I say,
12 well I'm going to go off on the side and I'm going
13 to do this. Now you look at the whole firm.
14 Would you be able to distinguish and say, you guys
15 move a lot of oil, a lot of energy is going back
16 and forth, and I see that. But what is this thing
17 that you're doing over here? You seem to have a
18 person who just buys oil for "speculative
19 purposes". Does that intermingle in such a way
20 that you can't distinguish "commercial" use of the
21 oil from speculative use? Or would you be able to
22 say, actually that does seem to be a distinct

1 activity from the commercial use of oil.

2 MR. OPPENHEIMER: And I'm having a hard
3 time because I don't know of any company who sort
4 of buys stuff off on the side, holds it. And I
5 can't envision that happening.

6 There are companies that, in the course
7 of being in the wholesale business, will buy and
8 sell. But ultimately, those products work through
9 and are a part of the commercial marketing chain.
10 I just can't envision what you're saying about
11 being outside of that scope.

12 MR. BERMAN: Okay, so most things would
13 be within -- you think would be in there -- so if
14 --

15 MR. OPPENHEIMER: Absolutely, yes.

16 MR. THUM: I would like to just make one
17 last point, that you know, there obviously are
18 three tests here. And the first test, I think,
19 includes this carve-out. The third test, of
20 course, excludes the carve-out, has different
21 thresholds. But one could say that if you're
22 getting a hedge fund which possibly is leveraged

1 -- and indeed, you're looking to consider all
2 trades for the purposes of establishing whether a
3 party is a major swap participant -- then the
4 third test would be the bucket that you'd probably
5 fit into.

6 MR. KYLE: And one final point for me.
7 Many -- if you look at where commodity scandals
8 come from, many times they come from large firms
9 that have small groups of traders in them that,
10 you know, kind of do things and aren't consistent
11 with maybe the philosophy of the whole firm. And
12 how are you going to -- and they create problems
13 in commodity markets from time to time.

14 So, how do you find those people and
15 monitor them? I'm thinking about the copper --
16 there was an example of a copper corner, you know,
17 many years ago. That was a Japanese firm. But,
18 you know, it was -- you could argue it was
19 commercial activity. But there was a huge
20 speculative element to it and it disrupted the
21 market quite a bit.

22 MR. STANLEY: And just to follow up on

1 that. I mean, we feel like you guys do face an
2 issue here in terms of defining more narrowly,
3 more precisely the definition of commercial.
4 Because especially you seem to have chosen to
5 interpret the statute to permit financial entities
6 to make use of this. There's potentially a real
7 camel's nose under the tent problem here that we
8 think you have to really look at. Because there
9 are speculative trading desks within energy
10 companies and other physical commodity companies
11 that also do commercial operations.

12 And the traders -- those speculative
13 traders are always going to be very aggressive
14 about trying to claim whatever exemption you've
15 created. This raises a lot of the same issues, I
16 think, that the Volcker Rule does with sort of a
17 ban on proprietary trading. And you have to look
18 at the practices within that company, how traders
19 are compensated, the overall hedge strategy for
20 that company. And specifically, tie those hedges
21 to narrowly defined commercial risks, we feel.

22 MR. FAJFAR: I think if we're ready to

1 wrap up, I would just like to say at the risk of
2 being repetitive and -- because I have pressed
3 some of the panelists on their points. There is
4 -- we have voluminous comment letters available.
5 We've had many meetings, they're all on the
6 record. And especially people reading the
7 transcript -- just be aware if you want more
8 information and a full explication of all of these
9 points, there's a lot more information on the
10 record. We're aware of that.

11 And this has just been a snapshot of the
12 issues. So, just want to make that clear for all
13 of the panelists on all three of the panels. And
14 otherwise, just thank you for participating.

15 And Josh, did you have anything?

16 MR. KANS: Thank you both to the
17 panelists and to the people in the audience for
18 staying with us for so long. Obviously, there's a
19 lot going on here. We haven't gotten anything
20 resolved, but I thought it was a very good
21 discussion and I very much appreciate it.

22 (Whereupon, at 4:09 p.m., the

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

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