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COMMODITY FUTURES TRADING COMMISSION

CFTC-SEC STAFF ROUNDTABLE
ON CAPITAL AND MARGIN FOR SWAPS AND
SECURITY-BASED SWAPS

Washington, D.C.

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1 P R O C E E D I N G S
2 (12:57 p.m.)
3 MR. RADHAKRISHNAN: Good afternoon. My
4 name is Ananda Radhakrishnan. I'm director of the
5 Division of Clearing and Intermediary Oversight at
6 the CFTC. I am pleased to open the Joint CFTC-SEC
7 Staff Public Roundtable to discuss issues related
8 to capital and margin requirements for swaps and
9 security-based swaps.
10 We also have with us today
11 representatives from the Board of Governors of the
12 Federal Reserve, the Office of the Comptroller of
13 Currency, the Federal Deposit Insurance
14 Corporation, the Farm Credit Administration, and
15 the Federal Housing Finance Agency who are
16 collectively referred to as the Prudential
17 Regulators under the Dodd- Frank Act.
18 This roundtable is only one example of
19 the close and collaborative relationship that the
20 staffs of the CFTC and the staff of the SEC have
21 developed together with the staffs of the
22 Prudential Regulators. As you all know, we have a

1 monumental task of coming up with rulemakings
2 within a one-year time period, and I'm very
3 grateful that the staffs of all the other agencies
4 have worked in such a close and collaborative
5 panel. And I would also like to thank the staff
6 of the SEC and CFTC for putting together this
7 roundtable.
8 As all of you know, the Dodd-Frank Act
9 for the first time brings over-the-counter
10 derivatives under comprehensive regulation, and
11 among other things it requires swap dealers and
12 major swap participants and security-based swaps
13 dealers and security-based major swap participants
14 -- and for convenience I'll just refer to them as
15 swap dealers and MSPs because otherwise it's a
16 major mouthful -- to either register with the CFTC
17 or the SEC, depending on the activities they
18 conduct and meet requirements for capital and
19 margin as established by the CFTC or the SEC or by
20 the Prudential Regulators. So essentially, if an
21 entity is a swap dealer or an MSP and is regulated
22 by the Prudential Regulator, then the Prudential

1 Regulator sets the capital and margin
2 requirements; if they're not, then the SEC and the
3 CFTC set the margin requirements and capital
4 requirements.
5 The purpose of the roundtable is to
6 permit the staffs of the regulatory agencies to
7 hear from a group of very distinguished panelists.
8 And here I'd like to thank all of you for agreeing
9 to participate, especially on a Friday afternoon.
10 And we'll look forward to your views and comments
11 on the key considerations for capital and margin
12 requirements applicable to dealers and MSPs. The
13 panel discussion today will be divided into two
14 areas. The first will concern margin requirements
15 and the second will concern issues relating to
16 capital.
17 Now, for the record, since this meeting
18 is recorded, I wish to state that all statements
19 and opinions that may be expressed by CFTC staff
20 and SEC staff, and I'm sure staff of the other
21 regulators, are opinions of themselves and do not
22 necessarily reflect the opinions of their

1 respective governing bodies. As I said, the
2 meeting is being recorded. If you wish to speak,
3 there's a red button -- you've got to push the
4 silver button and make sure that it lights up to
5 red and then you can hear. And also there's a
6 court reporter here so -- and she cannot see all
7 of your names. She's got a list of names but she
8 can't see all of your names, so before you speak,
9 if you will identify yourselves so that she can
10 make a record of it, that'll be great. And please
11 speak directly into the microphone.
12 Take your BlackBerrys. Don't leave them
13 on the table because it will interfere with the
14 audio. And a couple of housekeeping matters.
15 When we do have a break, there's a restroom out
16 here for men and women but then if you go down,
17 take the escalator down, there are two sets of
18 restrooms for men and women.
19 And now it gives me great pleasure to
20 invite my colleague, John Ramsay from the SEC, to
21 make his opening remarks. Thank you.
22 MR. RAMSAY: Thanks, Ananda. I won't

1 restate what you said but I did just want to say a
2 few things. The first is, again, thanks to the
3 staff of the agencies for helping to put this
4 together and, you know, thanks to the CFTC staff
5 generally for the very constructive, close and
6 collaborative relationship that they've
7 established with the staff of our agency on a
8 whole host of issues, certainly, this one
9 included. And it certainly has made the task, as
10 difficult as it is, far easier than it would have
11 been without that kind of relationship.
12 This particular set of rules that we're
13 required to adopt I would suggest is maybe as
14 challenging as any that we're going to need to
15 grapple with, both kind of on its own terms in
16 terms of figuring out what kinds of requirements
17 really are appropriate for this area where they've
18 not existed before. Also challenging from a
19 standpoint of trying to figure out how you
20 integrate or connect those requirements into the
21 existing requirements that already exist in terms
22 of capital, margin, and segregation, particularly

1 where you're talking about the activities of
2 integrated firms or where firms want to conduct a
3 whole range of activities within the same
4 institution.
5 So as a result, this is a -- these are
6 proposals where we always need good public comment
7 but this is something where we are especially
8 appreciative and it is important to reach out to a
9 wide range of market participants in order to get
10 some helpful comment. This is obviously a very
11 good step towards that goal, and again, thanks to
12 all of the distinguished people who have given
13 their time to be here.
14 MR. RADHAKRISHNAN: Thanks, John. So
15 let's start off and perhaps we'll get everybody on
16 the table to introduce themselves. Thank you.
17 MR. MACCHIARIOLI: Sorry. Mike
18 Macchiarioli, Securities and Exchange Commission,
19 financial responsibility to represent dealers.
20 MR. MCGOWAN: I'm Tom McGowan in trading
21 markets as well in net capital venture
22 responsibility.

1 MR. NICHOLAS: John Nicholas, Newedge,
2 USA.
3 MR. REILLEY: Bob Reilley from Shell
4 Energy.
5 MR. WOLLMAN: Bill Wollman from FINRA.
6 MR. LEITNER: I'm Tony Leitner. I guess
7 I'm representing myself but I am consulting with
8 the NYSE Euronext.
9 MR. HOLLOWAY: Mark Holloway, Goldman
10 Sachs.
11 MR. HEIS: Jim Heis, Noble Energy.
12 MR. DODD: Randall Dodd, formerly of the
13 CFTC staff and the Financial Policy Forum staff.
14 MR. CORNELI: Steve Corneli, NRG Energy.
15 MR. SHIMABUKURO: Ron Shimabukuro, OCC.
16 MS. REA: Laurie Rea, Farm Credit
17 Administration.
18 MR. FRENCH: George French, FDIC.
19 MR. HEMPHILL: Mike Hemphill, Federal
20 Housing Finance Agency.
21 MR. GIBSON: Mike Gibson from the
22 Federal Reserve Board.

1 MR. VISWANATHAN: Vish Viswanathan, Duke
2 University.
3 MR. TOURANGEAU: Mark Tourangeau,
4 NextEra Energy.
5 MR. WOODARD: Bill Woodard with
6 Williams.
7 MR. WASSON: Russ Wasson representing
8 the not- for-profit Energy and Users Coalition,
9 the National Rural Electric Cooperative
10 Association and the American Public Power
11 Association.
12 MR. CHAMBERS: Elliot Chambers,
13 Chesapeake Energy Corporation.
14 MR. DRISCOLL: Dan Driscoll, National
15 Futures Association.
16 MR. DENIZE: Yves Denize, TIAA-CREF.
17 MR. O'CONNOR: Steve O'Connor, Morgan
18 Stanley.
19 MR. LAWTON: John Lawton, CFTC.
20 MR. RADHAKRISHNAN: Thank you. And so
21 let's start off on the panel on margin. And
22 before we do so, I just want to make it clear

1 we're talking about margin requirements for
2 uncleared swaps. We're not talking about margin
3 requirements for cleared swaps. So, thank you.
4 So we'll hand it over to John to ask the
5 first question.
6 MR. RAMSAY: Thank you. So I guess
7 maybe I would suggest maybe we just launch
8 headlong into the topic that's attracted maybe
9 most of the attention in this area and the
10 appropriateness, need, etcetera, for margin
11 requirements to be applied to end-user entities.
12 I'd suggest maybe it would be most constructive if
13 we didn't focus so much on the legal authority
14 issue per say but I'd ask just from a statement of
15 policy perspective and how regulators and others
16 should sort of think about these things, how
17 people see the issue of margin again in the
18 uncleared environment, sort of tying into the
19 overall prudential limits. Or to put it another
20 way, if end-users as a group, if margin
21 requirements did not apply or if firms even absent
22 a requirement did not on a regular basis collect

1 margin from a number of end-user firms, would that
2 impact the overall stability, solvency? Would
3 that raise prudential concerns? And if so, why?
4 If not, why not? That's --
5 MR. RADHAKRISHNAN: I thought we'd go
6 down the table and get people's views. So, Steve,
7 do you want to start?
8 MR. O'CONNOR: Yes. Well, speaking from
9 a bank's perspective, this is background actually,
10 in our portfolio with clients, you know, we divide
11 the world into essentially four categories from a
12 margin perspective. There are those clients we
13 trade with that have no margin, so no IM or VM.
14 There are those that post VM-only and there are
15 those that post IM and VM and the IM that we
16 receive can -- sometimes we segregate it or not
17 segregate it. I'm sure we can get into those
18 issues. But for the un -- those clients with no
19 margin, which is typically corporations and
20 sovereigns, moving to margin we, you know, we
21 estimate is going to put a new demand for
22 financial resources on those end-users. We're

1 hearing this from our clients which, you know, has
2 a cost from their point of view. However, it does
3 reduce risk within the market so there's a
4 tradeoff there between, you know, a cost to the
5 end-user and the systemic reduction angle.
6 MR. DENIZE: I start when --
7 MR. RADHAKRISHNAN: If you just --
8 MR. DENIZE: Yes. Yves Denize from
9 TIAA-CREF. I think we started with the premise
10 that we support the goal of the legislation with
11 respect to clearing because we believe it does
12 have the intended benefit of mitigating systemic
13 risk. But the process by which we select the
14 swaps that are appropriate for clearing should be
15 a transparent process. It should be accessible
16 and provide end-users meaningful and effective
17 participation and input in the process. And
18 that's an important threshold issue because there
19 are swaps that will not move to clearing either
20 immediately or in the mid to -- near to
21 mid-future. And they're not not going to clearing
22 for sinister reasons; they're going to clearing

1 for fairly good reasons or benign reasons. They
2 may not be sufficiently standardized. There may
3 not be sufficient volume in those trades. The
4 clearinghouses may not be prepared to accept them
5 for clearing. The end-users, such as our
6 organizations or the similarly situated
7 organizations, may have particular needs,
8 customizable needs that need something different
9 than the standardized swaps that are going to be
10 pushed onto clearing. So there will be a bucket
11 of transactions that are not in the clearing space
12 that are uncleared but do not pose the systemic
13 risk concerns that force many of those swaps or
14 force the policy directive to push swaps into
15 clearing.
16 And so as we consider whether
17 incremental margins should apply, and if so what
18 amounts, we would urge implementation of a process
19 that can take into account relevant factors such
20 as the type of derivatives that are being engaged
21 in, the purposes of the trades, whether the credit
22 support arrangements are already in place

1 bilaterally and the sufficiency of those or the
2 basis as Steve just indicated that there might be
3 a very fine basis for not having margin exchanged,
4 and also the relative sophistication of the
5 counterparties. In effect, one size shouldn't fit
6 all scenarios and an approach that takes into
7 account those multiple factors should ensure that
8 we're not imposing unnecessary costs on strategies
9 that have appropriate risk profiles between
10 sophisticated parties and where those parties have
11 measured that risk, have appropriately mitigated
12 that risk with their own bilaterally negotiated
13 credit support arrangements.
14 MR. DRISCOLL: Dan Driscoll from NFA.
15 Like in most rulemakings, in this rulemaking
16 you're faced with balancing several competing
17 interests. Obviously, one of the major purposes
18 for the statute is to try to control systemic
19 risk. On the other hand you don't want to inhibit
20 legitimate business practices and make it harder
21 for commercial entities to hedge their commercial
22 risk. The two points I would make is that whether

1 there is a regulatory requirement for margin or
2 not, hopefully the counterparties that deal in
3 these kinds of transactions already have a robust
4 credit process, and in those situations where the
5 dealer believes that it's appropriate to have
6 collateral or margin, I would hope that that
7 already exists today.
8 In those situations which I can envision
9 where margin would not be required with regard to
10 end-user positions, and I realize capital is the
11 second roundtable today, I would think that in
12 situations where margin collateral is not
13 collected that it might be appropriate to look at
14 enhanced capital from the dealer because while
15 there might not be a lot of systemic risk, when
16 you don't have collateral it does increase the
17 risk.
18 MR. CHAMBERS: Elliott Chambers,
19 Chesapeake Energy.
20 Chesapeake extensively uses OTC
21 derivatives as part of their risk management
22 program. In fact, we exclusively use OTC

1 derivatives for the very reason that we are not
2 required to post cash. That is not to say that we
3 are accessing this market on an uncollateralized
4 basis. In fact, if you go back to the middle of
5 2008, Chesapeake owed roughly $6 billion on its
6 OTC contracts, but yet we had $11 billion of
7 non-cash collateral in the form of first lien
8 mortgages on oil and gas properties posted to our
9 counterparties, something we're very comfortable
10 with and we think provides very good coverage to
11 our counterparties in the event we have a run up
12 in prices.
13 We have a multi-counter party hedge
14 facility now that we put in place in the middle
15 of 2009 that has a line of credit, so to speak, to
16 Chesapeake of $15 billion. If we were to fully --
17 if we had a $15 billion mark, we would have to
18 post $25 billion worth of collateral, something we
19 are fine to do. We are ready to do that. But to
20 put that into perspective, sourcing $15 billion to
21 post this margin is impossible to our business
22 model. We are a cash poor -- we have a cash poor

1 business model, and I can say that speaking for
2 most energy end-users in that we would much rather
3 put our cash into finding new plays and drilling
4 more wells than posting it onto an exchange or to
5 our counterparties in the form of cash. In fact,
6 we'd have to make a cleared decision whether we
7 wanted to expand our operations or post cash onto
8 some sort of -- to counterparties.
9 We're going to choose the former for the
10 very reason that's our business. To choose the
11 latter would be a disaster. So we would focus on
12 continuing to post non- cash collateral and we
13 strongly urge that end-users be allowed to do so.
14 MR. WASSON: Russ Wasson with the
15 National Rural Electric Cooperative Association.
16 The vast majority of our members'
17 non-cleared energy swaps are completely unsecured
18 and without coll -- excuse me, collateralization
19 thresholds. And that's the way business has been
20 done in our industry for many, many decades. And
21 the reason that it's done that way is because our
22 counterparties know who we are. They make their

1 credit determinations based on their knowledge of
2 us. The non- cleared swaps with all -- basically
3 all electric utility end-users do not create
4 systemic risk. In fact, they're quite the
5 opposite. If we might borrow a term from the
6 utility business, they're a risk ground or risk
7 sink. And we don't pose any risk of cascading the
8 faults as you might see in the financial system.
9 Our counterparties know who we are. They ask for
10 credit support or collateral based on their own
11 credit decisions and what types of transactions we
12 do with them. And these relationships are very
13 longstanding. The commercial relationships and
14 each financial relationship is unique. They're
15 not -- they're not homogenous. Our counterparties
16 know we don't speculate; that the transactions we
17 do are to hedge commercial risk. We are pure
18 end-users in the sense that our commercial risk
19 that we're hedging is to protect our customers,
20 our members, our owners from price volatility
21 because our costs go up, our members have to pay
22 the price. We have no bifurcation between our

1 owners and third-party shareholders.
2 And I would just like to also make the
3 point that with respect to posting of non-cash
4 collateral, in a case of electric cooperatives and
5 municipal utilities, we were restricted or in some
6 cases prohibited from the posting of our
7 generating assets, our physical assets in the
8 forms of collateral.
9 MR. WOODARD: Excuse me. Bill Woodard
10 with Williams here.
11 Much like Chesapeake, we're a large
12 independent producer of natural gas with a wide
13 range of assets from pipelines to midstream assets
14 and again ENP production. And much like
15 Chesapeake, we use OTC derivatives to manage our
16 risk and hedge our risk.
17 At Williams, we are not against
18 clearing. A large portion of our business in
19 derivatives is cleared. But again, there's very
20 specific reasons for not clearing part of it. And
21 again, our ENP production, as Chesapeake, we have
22 a multi-counterparty facility set up as well where

1 reserves and assets back those margins. And also,
2 you know, the other big reason is we sell a large
3 amount of physical gas that, you know, which we
4 have credit exposure on one side. And in order to
5 offset that credit exposure with netting
6 agreements and so forth, oftentimes we will go out
7 and do a derivative on the other side to limit our
8 credit risk. And again, you know, from a business
9 model standpoint just as Chesapeake, we would have
10 to make that decision if noncash collateral were
11 taken away whether to hedge and put that capital
12 towards posting margin or whether to put it
13 towards drilling, producing, and finding
14 resources.
15 MR. TOURANGEAU: Mark Tourangeau with
16 NextEra Energy.
17 NextEra operates two businesses --
18 Florida Power and Light, which is a large
19 investor-owned utility in Florida, and also
20 NextEra Energy Resources, which is one of the
21 largest owners of renewable resources in the
22 country. We rely on a system currently that's --

1 that is principle- based that allows the prudent
2 extension of unsecured credit to our
3 counterparties and to us. It allows for master
4 contracts that allow netting across physical and
5 financial products and also across commodities.
6 It also requires margining only for net exposure
7 above those thresholds or the limits that we're
8 setting through our credit risk managed policies
9 and that our counterparties are setting as well.
10 This is a principle-based system that has worked
11 well for many, many years and it has worked
12 through a number of high profile bankruptcies
13 where those bankruptcies have not spread and no
14 systemic risk has been caused to the greater
15 financial system.
16 If we were to move away from this type
17 of system where margining is required both on an
18 independent amount or initial margin -- and again
19 I'd stress those two terms are not transferrable
20 or equal, or on a variation margin, again which
21 from a cleared perspective does not mean the same
22 thing as a margining that occurs in the

1 non-cleared world which is a problem with what
2 we're dealing with right now just in terms of the
3 definitions -- if we were to move away from that,
4 you know, there's going to be three implications
5 to that. The first is increased costs to end-
6 users because a lot of the capital that has been
7 used for other things is going to be tied up in
8 that margining. It also will force a lot of
9 end-users to use fewer risk management tools as
10 Chesapeake mentioned in order to hedge their --
11 either their production or their output. Sorry,
12 or their load. And it will also reduce
13 investments in the capital assets and in the
14 people that are desperately needed to run these
15 businesses and to -- essentially to keep the
16 economy moving.
17 So, especially given the times that
18 we're in right now, the economic conditions, to
19 tie up this type of capital in margining when it
20 could be used by the end-users to put to use for
21 productive capital would be the wrong way to go.
22 MR. VISWANATHAN: Hi, this is Professor

1 Vish Viswanathan from Duke.
2 I guess the real question here is we're
3 trying to substitute a credit process with a
4 collateral process. Margining in some sense makes
5 it easier for the regulator to reduce systemic
6 risk because you have a better understanding of
7 exposures being limited. But in doing so you're
8 kind of saying in some sense that perhaps the
9 credit process is not working as well as it should
10 be. And the question then arises, you know, is
11 that the case? Is there any evidence that these
12 bilateral relationships have not over the long run
13 in fact been managed well?
14 The other issue which one might want to
15 think about is is there some risk transfer taking
16 place that right now implicitly because there's a
17 credit process the risk of the credit is taken by
18 the counterparty who might know more about the
19 transaction. If you ask me to take a line of
20 credit and post collateral, you're now passing the
21 credit risk over to another financial
22 intermediary. And the question is who is better

1 in some sense to assess the credit risk? Is it
2 the bank or somebody who gave you the line of
3 credit or the counterparty in this transaction?
4 But my suspicion is that because swap
5 dealers will be asked to post margins under the
6 new rules -- I don't know how much capital they'll
7 be asked to put up -- they will want to reduce
8 that and to some extent they will ask for margin
9 from the counterparties so you might see this
10 happening as a consequence of greater margin
11 requirements of the dealers themselves.
12 MR. CORNELI: Steve Corneli, NRG Energy.
13 NRG is a large independent power producer. The
14 non-regulated half of NextEra's business is very
15 much like ours, and from a corporate perspective
16 we very much share the concerns expressed by
17 Chesapeake and NextEra and others that imposing an
18 additional margining requirement on businesses
19 like ours, in addition to the margin or collateral
20 that we already provide that we think is entirely
21 sufficient for protecting both ours and our
22 counterparties' exposure and our trades with them

1 in the OTC market would divert cash away from
2 critically important investments that in our
3 company we're making in clean energy projects
4 ranging from nuclear power plant development to
5 electrical vehicle charging infrastructure and
6 solar investments that we think are needed, both
7 for our business and actually for the U.S. economy
8 to succeed.
9 But I want to go back to your question
10 which was -- if I understood it was about exempt
11 -- about non-cleared derivatives. And the way we
12 think about this is there's two basic ways a
13 derivative could be uncleared under the Dodd-Frank
14 framework. One is if you all decide that it's not
15 ready to be moved into an exchange or if it's
16 cleared or doesn't need to be. The second way,
17 which is I think of particular importance to all
18 the end-users here is even if it is that type, as
19 end-users the Dodd-Frank end-user exemption would
20 allow us to continue to trade those derivatives
21 over the counter. So what I want to suggest is in
22 addition to all the arguments and concerns that

1 have been laid out by other end-users here and the
2 very appropriate questions and focus raised by the
3 professor from Duke, is a focus on the difference
4 between those two categories. There may be -- and
5 I'm not saying there are -- but there may be
6 uncleared derivatives that are not -- not used by
7 end-users. That could be in a financial entity to
8 financial entity arrangement that both from a
9 legal perspective and a policy perspective raise
10 questions -- raise the question that you asked.
11 And we're not prepared to say that
12 there's a problem there; we're not prepared to say
13 that there isn't. But what we are prepared to say
14 is that there is not a problem with the other
15 category of derivatives, the end- user OTC
16 derivatives that are uncleared because of the end-
17 user exemption. And really there's two reasons
18 for that. One is that we're already commercially
19 -- as the gentleman from TIAA suggested -- we're
20 already providing collateral for our exposure and
21 demanding it of our counterparties. And we often
22 provide collateral through first liens or asset

1 backed non-cash collateral, which actually is a
2 very efficient form of providing collateral that
3 matches and rises and falls with the actual net
4 position that we're facing. We are even more
5 efficient because as other panelists have
6 mentioned, we net out credit across our book and
7 are able to provide ample collateral without
8 wasting cash. So from that perspective it would
9 be redundant and wasteful to actually impose
10 margin requirements on this category of end-user
11 transactions.
12 And finally, it would have no real
13 public purpose because, as other parties have
14 pointed out, we do not through these trading
15 operations or hedging practices create systemic
16 risk or augment it. And in fact, in many ways we
17 help reduce it.
18 So for that specific category I hope
19 I've answered your question. To sum up, it
20 wouldn't cause any additional systemic risk. It
21 wouldn't cause any additional firm level risk.
22 And it would divert important resources and lead

1 to an inefficient result to require margining on
2 that set of exempt or uncleared transactions.
3 MR. DODD: Hi, my name is Randall Dodd.
4 Let me -- a lot's already been said so let me add
5 something that I haven't heard yet that I think
6 needs to be said. That there is a systemic or
7 stability issue involving margin. Margin is
8 designed to address expected losses. Not
9 unexpected, but expected losses. And that helps
10 make the system more stable. Is there are cases
11 in which the lack of margin has caused the system
12 to lack stability? Yes. Let me think of a couple
13 that involve end-users.
14 One, very recently, about two years ago,
15 is AIG. They were essentially an end-user. They
16 sold protection. They had not a netted down
17 position; they had a gross exposure. The
18 counterparties didn't require margin initially of
19 AIG because of its high credit rating. But when
20 the credit rating changed and changed fairly
21 suddenly, suddenly margin becomes very essential.
22 People, such as the gentleman here from Goldman,

1 can help me in more details on this part because
2 their relationship to AIG regarding margins is now
3 pretty public and has been discussed. When it
4 came time for them to ask margin from AIG, AIG
5 wasn't prepared to provide it. They had assets
6 but they weren't liquid assets. So pledging
7 illiquid physical assets is important, it's
8 useful, but is it sufficient? And AIG didn't have
9 the liquid assets at the time.
10 And as a result, Goldman was in a bind.
11 If they didn't get the $6 billion from AIG, how
12 could Goldman post margin to their counterparties
13 they laid off that risk with? Goldman had bought
14 protection from AIG, turned around and sold the
15 protection to other people. The other people now
16 wanted that collateral from Goldman. If Goldman
17 couldn't get it from AIG, where are they going to
18 get the $6 billion?
19 So when one set of counterparties
20 doesn't post margin, how is the dealer going to
21 maintain their book and be able to provide margin
22 to the next person? And that can create a chain

1 reaction or a cascading kind of a problem.
2 Now, there are other ways to solve it
3 other than just requiring the end-users to post
4 cash. It could be that, as the professor
5 suggested, you know, get a line of credit. And
6 then some other bank has budgeted for an emergency
7 provision of cash to the end-users to provide as
8 collateral. Now, that's going to cost you money.
9 That's true. And you guys don't want to have any
10 more cost; I don't want to have any more cost.
11 But the cost of doing business safely often does
12 involve initially higher costs. The cost of
13 anti-lock brakes is higher than normal brakes but
14 it makes the whole freeway system and
15 transportation cheaper and safer. All right? So
16 is it cost effective? Yes. Does it immediately
17 pose a cost to the individual? That's true, too.
18 And so we need to decide here what kind of level
19 of individual cost is fair to impose to make the
20 whole system safer and in the long run cheaper but
21 in the short run you have an individual cost to
22 cover.

1 The other example I could mention here
2 about the stability issue is, you know, Enron
3 didn't use collateral. And it had two
4 consequences. One, you drove out some of the
5 exchange traded products from the market, like the
6 electricity contract on NYMEX, because they did
7 charge margin. So it created an unlevel playing
8 field. Two, when Enron started to get into
9 trouble they quickly collapsed because of
10 essentially I think it was Skilling and Lay said
11 it was a run on the bank. People quit trading
12 with them because they knew all their transactions
13 were uncollateralized.
14 And so again, the lack of that
15 collateral or margin in the system left it very
16 susceptible. And so we need to bear that in mind,
17 that this does provide a problem. You guys didn't
18 cause a problem during the crisis but -- and
19 that's true. That's great. But this kind of
20 situation did. And we don't know where the next
21 crisis is going to occur or originate from. And
22 so we need to be thinking about those economic

1 factors as we design good public policy.
2 Thanks.
3 MR. HEIS: My name is Jim Heis. I'm
4 with Noble Energy, and I'm here today on behalf of
5 the IPAA.
6 We, similar in that, we do most of our
7 hedging -- companies like Noble and IPAA will do
8 most of our hedging using exclusively OTC
9 derivatives. And we feel that imposing margin
10 requirements on companies like Noble would divert
11 capital away from the capital drilling program.
12 And also introduces another risk of increased
13 financial liquidity risk in that when as we
14 continue our hedging programs as oil and gas
15 prices are moving higher and higher, which is
16 exactly the time when more energy supply is needed
17 to bring the demand-supply more into balance would
18 be the time when there is an increased cash demand
19 to us. And we feel and we urge the Commission to
20 clearly define who the end-users are and to exempt
21 those end-users from posting of any margin
22 requirements or from having to post any cash

1 collateral. Companies like Noble, we have strong
2 balance sheets. Right now we have no posting
3 requirements with any financial counterparty. And
4 this is important to us. I mean, it provides us
5 the opportunity to really invest in domestic
6 basins where we can provide ongoing effective
7 costs or energy supply for the country. And we
8 would encourage the Commission to proceed with
9 rulemaking that allows the industry to proceed
10 with the current hedge practices and we think it's
11 important to keep the money in the business and
12 not in someone else's pocket.
13 Thank you.
14 MR. HOLLOWAY: Mark Holloway from
15 Goldman Sachs. I'd like to pick up on a comment
16 or comments by Dan Driscoll of the NFA and the
17 professor from Duke. Our thought is if the CFTC
18 and SEC and other regulators structure the capital
19 rules for the swap dealers or swap transactions in
20 a manner consistent with the way they've
21 structured rules for other types of transactions
22 that we -- the rule set will include provisions

1 addressing credit exposure and the potential
2 liquidity drains that are associated with
3 extending unsecured credit. We obviously don't
4 know what those rules are yet but we would, as I
5 said, if history is a precedent we would expect to
6 see those sorts of provisions in the rule
7 structure.
8 Thank you.
9 MR. LEITNER: Tony Leitner. Listening
10 to most of the subcommunities talking in the pure
11 commodity context, I'm associated in my
12 professional life more on the equity and financial
13 products side of the business, but I'd like to
14 cite maybe a couple of helpful analogies that I
15 draw from what I've heard, which is -- and the
16 firm I was formerly associated with became both a
17 market and financial intermediary. And it's this
18 financial and market intermediation that is made
19 possible in large part because there are liquid
20 markets for dealers to, in fact, manage the risks
21 when they are writing over-the-counter product in
22 many of the areas that you're talking about. And

1 we know that these products have evolved over time
2 in large measure because of those things.
3 To me, the Enron, or I'm sorry, the AIG
4 credit derivative issue points out the question
5 about whether the consequences of being in a
6 business, whether the risks are being fairly
7 charged. If -- that's why capital requirements
8 and collateral or margin it seems to me go
9 hand-in-hand. Should there be a one size fits all
10 solution to the problem? I think the answer to
11 that is no. There have to be for good commercial
12 reasons a reasonable amount of flexibility
13 depending on the market that you're talking about.
14 As you get closer to markets that are truly public
15 markets, like equity securities, bonds, things
16 like that, liquidity factors and similar issues
17 raise the greatest level of systemic concerns. In
18 these sub-markets, it seems to me one needs to
19 look at how well they are doing and whether those
20 who are providing the intermediation, both credit
21 and market, are taking into account and being --
22 the true cost of being in that business and those

1 costs are being assessed.
2 The unlevel playing field that's
3 occurred is because, you know, the United States
4 has had a set of rules with capital requirements
5 and margin requirements in many areas and other
6 parts of the world have not. And so we also have
7 to be worried, I think to some extent, about the
8 degree to which anything that happens on the
9 regulatory side here may lead to arbitrage. So
10 being sensible about how you -- both the CFTC and
11 the SEC approach these issues I think is very
12 important. But making sure that risks are
13 properly priced and the costs taken into account
14 is I think part of the key.
15 MR. WOLLMAN: Bill Wollman with FINRA.
16 We currently have responsibility for monitoring
17 the financial responsibility rules for the largest
18 broker- dealers. We currently do have margin
19 rules in place on the securities side, and those
20 rules are designed to instill safety and soundness
21 standards so that it protects not only the dealers
22 but also their customers. The dealers have a lot

1 of exposure to their end clients in the form of
2 balances they hold and security positions that
3 they owe. The idea of not collecting margin from
4 potential counterparties, we've heard two themes
5 so far and I agree with them. It does keep the
6 credit risk at the dealer, which may or may not be
7 prudent. As Mr. Driscoll pointed out, there are
8 extended risk systems in place to evaluate that
9 credit risk. It potentially does transfer that
10 credit risk to other people that don't know they
11 have it, such as other clients of the firm. And
12 that's one thing that I think would have to be
13 discussed and considered before a decision is made
14 to not collect margin from certain counterparties.
15 The other thing which is even more
16 potentially problematic is the liquidity risk
17 because in a lot of cases the capital impact of
18 having two-sided transactions may not result in
19 large capital charges but if one side -- if an
20 intermediary in a transaction is posting
21 collateral on the one side and not collecting from
22 another, it could create extensive liquidity

1 problems which are really something that would
2 quickly develop into a problem in terms of causing
3 potential problems with that dealer or other
4 people that are dealing with them.
5 So I don't think it's clear as to
6 whether certain people should or shouldn't be
7 exempted but I certainly think there are a lot of
8 other impacts by making that type of decision.
9 And certainly, you know, we've come from this idea
10 of margin rules reducing risks so I certainly
11 think at a minimum some standard of collecting
12 variation margin would be appropriate, you know,
13 to reduce some of those risks that we spoke about.
14 MR. REILLEY: Bob Reilley from Shell
15 Trading. First, I'd point out that we clear
16 roughly 80 percent of our OTC swaps. For the
17 remaining 20 percent, we think there are good
18 reasons they are not cleared which mainly have to
19 do with using our capital efficiently. But I
20 don't think that means that these things aren't
21 carefully scrutinized. We think the banks do a
22 pretty good job of that to tell you the truth.

1 And also, you need to keep in mind these
2 are all unsecured. All right? We have a lot of
3 collateral posted. Other lines are secured by
4 netting agreements. At least our net exposure is
5 minimized through netting agreements. We do think
6 that to the extent that there is unsecured
7 exposure here that it's carefully managed. This
8 is a standard and time tested approach and I think
9 that it has proven to work very well, at least in
10 the markets that we operate in that involve energy
11 commodities.
12 A couple of other points we think are
13 important in this area is that, of course, clearly
14 we don't think margin ought to be imposed on
15 transactions with end-users. We don't think it
16 should be imposed on transactions between
17 affiliates. Netting needs to be recognized and
18 non-cash collateral, several different forms, is
19 very important to us.
20 MR. NICHOLAS: John Nicholas from
21 Newedge. We're a U.S. broker-dealer and futures
22 commission merchant.

1 And our take on this situation is, you
2 know, obviously we understand the importance of
3 margin and reducing systemic risk. However, we
4 are also very sensitive to the issues of the
5 end-users. So I think what our consensus is is
6 that this is a time to be creative. This is a
7 time to consider, as has been mentioned already on
8 a number of occasions, the ability to use non-cash
9 collateral. We think that's a critical ability of
10 end- users to be able to do that. And I know this
11 isn't the exact topic but jumping ahead a little
12 bit to cleared derivatives, the monetization of
13 non-cash collateral through third-party banks I
14 think is something that should be considered.
15 The other point I think worth mentioning
16 is in determining whether the appropriate balance
17 is struck between systemic risk and margin
18 requirements, we would urge the Commission to look
19 closely at counterparties' abilities to detect and
20 manage risk. I think there are counterparties
21 obviously that have very sophisticated systems and
22 the ability to detect and manage risk. And I

1 think that should be one of the factors taken into
2 account.
3 Thank you.
4 MR. RADHAKRISHNAN: Thank you. So no
5 surprise. The responses from the end-users is,
6 you know, not us.
7 I want to make one point. There is a
8 provision in the law which does require the
9 regulators to permit the use of non-cash
10 collateral. So it is counterplay in Dodd- Frank.
11 But let me go to another point, which is is it
12 appropriate for the commissions or the CFTC to
13 make a distinction between what I would call
14 financial entity end- users and everybody else?
15 The reason I ask that is because if you look at
16 the clearing exception, it may be similar in the
17 securities laws. Financial entities don't get a
18 break from clearing. Of course, the issue is what
19 is a financial entity. But let's say that we all
20 know what a financial entity is. They don't get a
21 break from clearing so they basically have to
22 clear.

1 But there might be instances where
2 because no clearinghouse wants to clear a
3 particular kind of swap, a financial entity will
4 end up doing a purely bilaterally deal. It's
5 appropriate for the Commission to make a
6 distinction and say since Congress made a
7 distinction between financial end-users and
8 non-financial end-users, is it appropriate for the
9 commissions to impose margin requirements on
10 financial entity end-users? Question number one.
11 Question number two, let's say the
12 Commission decides not -- Commission -- I'll speak
13 with the CFTC. The Commission decides not to
14 impose margin requirements on end-users. Is it
15 nevertheless appropriate for the Commission to
16 impose a margin requirement on the swap dealer,
17 you know, the swap dealer side of the transaction?
18 In other words, the swap dealer has to post
19 margin; the end-user doesn't have to post margin.
20 And whoever wants to answer, you know, put up your
21 hand. I'll recognize you and you guys can go.
22 Nobody wants to talk today?

1 MR. LEITNER: I'm not sure you can
2 answer that without asking whether the financial
3 firm is providing a market function as well as a
4 credit function. If -- because I think the
5 pattern has been that the -- whether or not the
6 financial firm, before there were any regulations,
7 was asked to provide collateral, and I think many
8 counterparties saw that in connection with any
9 swaps exposure the exposures could go either way
10 and therefore, there were many, I think,
11 counterparties that said, well, wait a minute.
12 You know, you're asking for collateral from me but
13 what about when I'm exposed to you? What are my
14 rights? And most financial firms would say, well,
15 no, we're asymmetric because we're already being
16 -- the costs of dealing with you are already being
17 taken into account and I have capital charges and
18 capital consequences for the business that I'm
19 doing. And therefore, you're protected because
20 the regulator is overseeing my costs. And this is
21 the point I was making before, imposing those
22 costs. So if the pricing of the risks are

1 appropriately taken into account by the financial
2 intermediary, then imposing an additional
3 requirement to post collateral is an additional
4 cost because now you have to go into the liquidity
5 pool, especially if it's asymmetric. In other
6 words, you're not collecting collateral on the
7 other side. If it's a purely matched transaction
8 and you're getting the variation in and you're
9 paying it out, who cares? But if it has to get
10 stuck somewhere then it's asymmetric.
11 So I'm not sure that answers the
12 question but those are factors to be taken into
13 account. I guess in answer to your question
14 should you distinguish financial firms from other
15 types of end-users? I would say yes if they are
16 performing this market function and creating
17 liquidity for their end-user community.
18 MR. CORNELI: Steve Corneli, NRG. Maybe
19 I'll take your questions in reverse order.
20 So the question was if margin
21 requirements were not imposed on end-users should
22 they be imposed on swap dealers who are on the

1 other side of trades with end-users? I think one
2 way of thinking -- without going into the question
3 of legislative intent and, you know, it's our view
4 and that of many of us, that there's a clear
5 legislative intent that says you should not do
6 that. But let's leave that aside.
7 Just on the merits, so to speak, the
8 fundamental issue there I think is if that
9 transaction, if the end-user is already requiring
10 an appropriate level of margin on that swap
11 dealer, there really is very little merit or
12 rationale in terms of preventing systemic risk or
13 preventing an excessive sort of set of exposure
14 that could cascade from firm to firm and adding
15 more on top of that. So what would be the --
16 without some clear public purpose, even if it is
17 authorized or intended by the statute, there seems
18 to be, you know, no good reason for doing that if
19 there is an adequate bilateral arrangement between
20 the end-user to take care of that problem and we
21 would join others in asserting that we do that.
22 You know, we don't take on counterparty risk

1 gratuitously or in any way that we think is
2 inappropriate.
3 Now, going back to the first question
4 which is a bit more difficult for me to answer,
5 what about uncleared transactions between
6 financial entities I think was --
7 MR. RADHAKRISHNAN: Oh, if you have,
8 let's say you have a transaction between a
9 financial entity end-user and a swap dealer and it
10 is not -- it is bilateral because it doesn't have
11 to be clear. No clearinghouse wants to clear it,
12 so.
13 MR. CORNELI: Right. So outside of this
14 end-user exemption, I think there's two layers of
15 question. One is really kind of informed by the
16 statute, which is if this is -- is it a major swap
17 participant or a swap dealer thinking that the
18 guidance in the statute -- and from what we've
19 seen so far of the Commission's guidance or
20 suggested rule on the definitions, a major swap
21 participant is per se an entity that can or does
22 contribute to systemic risk. So if there is a per

1 se systemic risk problem, then it seems that there
2 ought to be measures taken to address that
3 systemic risk and they may be involved in the area
4 of margining and capital or they may be entirely
5 other issues.
6 If there is no systemic risk in this but
7 it's just simply a matter of this is a category
8 that is identified in the statute that you have to
9 attend to in your rulemaking, it would seem that
10 it would be good to go back to like is there a
11 public purpose in doing this other than just, you
12 know, we can do it. And identifying whether or
13 not there is adequate bilateral, including netting
14 of the various positions that are taking coverage
15 for the counterparty risk that they're creating
16 amongst themselves. If there is, the system is
17 working. If there is some sort of negative
18 externality around risk that could be piling up as
19 was the case with AIG which I think would be an
20 MSP in today's, you know, in your future world,
21 that would be all the people who are buying and
22 speculating on the same CDSs over and over again

1 would clearly be MSPs or financial entities and
2 not end-users. Then it would seem to me that
3 would be an area where you could try to de-risk
4 that.
5 MR. O'CONNOR: There we go. So --
6 MR. RADHAKRISHNAN: Your name.
7 MR. O'CONNOR: Steve O'Connor. A quick
8 clarifying question, Ananda, going to the second
9 point. If a dealer has to post collateral and the
10 end-user does not, I imagine the scenario you're
11 pointing to is that if particularly a derivative
12 might have zero value on day one and you're saying
13 if it moves in the money in the favor of the
14 dealer he doesn't call collateral and therefore,
15 the end-user isn't subject to those extra costs
16 that we've been hearing about. But if it moves in
17 favor of the client the dealer has to post
18 collateral. Okay.
19 I think that the point made by Mr.
20 Leitner was correct in the sense that -- well,
21 there were two consequences of that. One is that
22 the dealers face a large liquidity call. And if

1 you look to -- this is publicly disclosed in the
2 10Qs with the banks -- the uncollateralized
3 derivatives of the leading market makers -- and it
4 is market making here where dealers typically have
5 balanced books intermediating between clients, the
6 numbers there get pretty large. So the average
7 uncollateralized derivative receivable and payable
8 is typically of the order of $50 billion to $100
9 billion at a large bank. So across the industry I
10 would guess that that would be, you know, a
11 trillion dollars of liquidity that would be needed
12 to fund those margin calls which is money coming
13 off banks' balance sheets that would ordinarily be
14 deployed into the economy for lending, etcetera,
15 etcetera. So that's one perhaps unintended
16 consequence of that.
17 The other is that the cost of doing
18 business would go up, which would lead to a bit
19 off of widening. So if I'm pricing a derivative
20 where I know that in every situation where I owe
21 the client I have to raise debt to fund that
22 there's a cost there that has to be reflected. So

1 that would have an enormous effect on the bid
2 offer pricing shown by market makers. So I think
3 it would be bad for those two reasons.
4 MR. LEITNER: Just one other quick
5 point.
6 MR. RADHAKRISHNAN: Randall wanted to
7 say something. Go ahead.
8 MR. DODD: Yeah, jut briefly. If I
9 understood the question right you're asking how to
10 distinguish between non-financial and financial
11 end-users.
12 MR. RADHAKRISHNAN: Should we
13 distinguish between --
14 MR. DODD: Yes. Should we implicitly
15 then, you know, how to think about that. And one
16 thing I want to throw out that I hadn't heard yet
17 was that we should bear in mind that financial
18 institutions are going to have a lot of liquid
19 assets. And so the problem of not having liquid
20 assets to post as margin wouldn't be the same
21 burden as it would be for nonfinancial end-users
22 that have physical, non-liquid assets.

1 And so particularly I think if a
2 financial institution can post those -- their
3 current liquid assets in an segregated account
4 with the derivatives counterparty, then from what
5 I understand of accounting rules, you could still
6 report that as an asset for that firm because it's
7 not being refused or reapothecated because it's in
8 a segregated account. So that would be a
9 relatively or almost negligible cost to the
10 financial firm to meet that margin requirement,
11 unlike there would be some explicit credit -- line
12 of credit costs for the firms with less liquid
13 assets.
14 Regarding your question then, and it
15 goes back to a solution to the problem with the
16 non-financial end-users, is that if we don't ask
17 them to post margin, then -- and we recognize the
18 concern that the system will not have a balanced
19 flow of margin as price movements change in the
20 market, then the other alternative is to insist
21 that the dealers internalize that relationship and
22 acquire lines of credit to meet their unfunded or

1 unmargined exposures. And that would then maybe
2 be more -- an explicit price add-on to their
3 bilaterally derivatives trading with the end-user.
4 Or not -- might not be transparent but hopefully
5 would. But that would be the other way to do it.
6 You know, someone's got to pay it. If the
7 end-users want to pay it then you could just --
8 ultimately you're going to pay it but now
9 indirectly because the dealer would be having to
10 bear that burden.
11 MR. DENIZE: Yves Denize from TIAA-CREF.
12 Not an energy company but a financial services
13 institution. It's primarily an insurance company
14 as doing most of its derivatives trading.
15 The concern about, you know, forcing a
16 distinction between financial and what the
17 legislation points out is commercial -- my opening
18 comments I wanted to talk about a process that
19 looked at what was actually occurring on those
20 trades. And so you can simply -- you could have a
21 financial entity end-user that's not creating a
22 market or is not an MSP and churning CDS, but in

1 our context, you know, having some very valid and
2 prudential derivative strategies that are subject
3 to prudent and actually vigorous regulation from
4 its states and other jurisdictions, and there you
5 go through the same questions I asked before. Do
6 you need from a regulator's perspective to impose
7 additional margin to a scenario where there's been
8 some risk mitigation and risk assessment? And in
9 many cases, the gentleman was right, we do have
10 liquid assets. We may be posting margin on a
11 bilateral basis. It may simply not be the same
12 blanket margin requirement you might put across
13 all uncleared swaps.
14 And so from my perspective, personally I
15 would think that we'd want a process that really
16 was dynamic, that could look into these various
17 scenarios, and when you see whether you call us a
18 financial entity end-user or not, where you see an
19 end-user that is pursuing a bona fide derivatives
20 strategy, it's prudentially applying that strategy
21 with risk mitigance and a properly calibrated
22 credit support arrangement. There should be room

1 to not have a -- if not an arbitrarily blanket
2 imposed regulatory cost or additional margin.
3 MR. LEITNER: I'm going to try to make
4 this fairly complicated point simple. But among
5 the policy objectives, I think both of the
6 regulators need to take into apart the two account
7 is whether at least for the intermediaries --
8 whether you want to encourage a consolidation of
9 function or disbursal of function. We now have,
10 you know, two regulated entities at this table,
11 broker dealers, and bank-owned broker dealers. I
12 guess you could have three. And FCMs. But then
13 you have, you know, traditionally we've had swap
14 dealers. Why have we had swap dealers? We've had
15 swap dealers because the capital -- they fell into
16 a black hole. I mean, you didn't want to bring
17 them into the broker dealer because the capital
18 charges for unsecured credit exposures would
19 basically "break the bank."
20 Does that make sense? Do we want a silo
21 product? I don't think so. I mean, I think that
22 ideally you would want to bring exposures,

1 especially exposures that are related, into one
2 place so that appropriate offsets can be taken
3 into account. So I think we have to be careful,
4 and I would hope that we would just keep in the
5 back of our minds that siloing these issues as to
6 particular types of products or over-the-counter
7 versus cleared and so forth without taking into
8 account the relationships through which these
9 products are used and the ability to -- using one
10 of my favorite terms -- portfolio margin the
11 relationships and take into -- one would want to
12 reduce systemic risk by being able to put them in
13 one place and encourage it.
14 So while you are debating under the
15 statute the need to address these, you know, kind
16 of product, that is swaps-associated products, to
17 me a swap on an equity or a swap on an equity
18 index or an option on an equity index or a single
19 stock future or future, they're all related. The
20 idea that they would have to be done in different
21 places or be subject to different rules is kind of
22 crazy.

1 MR. RAMSAY: Tony, you sort of
2 anticipated my question which was, or to maybe
3 frame it a different way and see if there's
4 another reaction to it, part of how you look at
5 this question may depend on assumptions about who
6 the end party end-user is squaring off against.
7 Right? At one end if you have a sort of
8 standalone dedicated swap dealer --
9 securities-based swap dealer who is only doing
10 that business, that sort of one business model,
11 our assumption, what we've sort of been hearing in
12 general terms from the largest financial service
13 firms is that their preference in part, I guess,
14 depending on how the regulations shake out, is to
15 be able to conduct as much business in one place
16 as possible so that, you know, and certainly from
17 a client standpoint that has some clear advantages
18 in terms of netting and other things. So the, you
19 know, the largest firms in the SEC world, for
20 example, that are subject to an alternative net
21 capital regime would, you know, there is some
22 apparent benefits to being able to put whatever

1 swap business they're conducting or
2 securities-based other swap business into that
3 entity.
4 How do -- one of the things I guess
5 we're struggling with is if one assumes in that
6 context that you have this, you know, sort of
7 fairly comprehensive integrated margining scheme
8 that's applying to all of that business that's
9 conducted there, do you, you know, is it feasible
10 to have some portion of the business that they
11 then take on subject to a different sort of
12 scheme? Or, you know, would you have to do it on
13 a client-by-client basis? That is, in terms, and
14 we're not talking specifically --
15 XXXTRACK 2 BEGINSXXX MR. LEITNER: I
16 guess my only point is that as the SEC and the
17 CFTC consider the rules for their own regimes,
18 which are not entirely parallel in so many
19 respects, that an effort is made to kind of look
20 at where the requirements of each statute can be
21 met with as much parallelism as possible. So, and
22 I think you were asked to do that under this

1 legislation in any case. To me it's always made,
2 for example, sense that portfolio margining of
3 derivatives can be -- is kind of a different
4 animal than where you are dealing with cash market
5 products at the same time. So it may well be that
6 thinking in terms of function, that is is the --
7 giving firms the flexibility to choose the way to
8 accomplish portfolio margining by being enabling
9 would be a great -- would be a great help. But,
10 you know, this is -- has less I think to do with
11 many of the participants in this particular
12 meeting whose concerns are really related to these
13 communities of commercial needs that are separate
14 from what's going on in the, you know, the
15 financial markets.
16 MR. TOURANGEAU: Yeah, to that point I
17 think I want to redirect it a little bit and talk
18 about, you know, from a selfish perspective.
19 MR. RADHAKRISHNAN: Sorry, could you
20 just identify yourself?
21 MR. TOURANGEAU: Sorry. Mark
22 Tourangeau, NextEra.

1 You know, when we talk about Enron or
2 AIG or anything like that in the context of
3 Frank-Dodd, I don't think either of those entities
4 would have been qualified as an end-user under the
5 business that they were conducting at that time.
6 They would either have been an SD or a major swap
7 participant. So from that perspective I think
8 they would have been, under Dodd-Frank, margining
9 fully or, you know, on an exchange.
10 You know, when we talk about the
11 end-user business for energy, you know, anyone who
12 is qualified under an SD or MSP, it's a pretty
13 broad category the way it's currently defined.
14 You know, you're going to have a lot of business
15 in the energy industry that's moving to cleared if
16 anyone falls under that, except for people that
17 qualify as an end-user. Right now, energy in the
18 derivative OTC market is a very small part of that
19 market. I think three percent or something is
20 what I've heard. So when we continue to talk
21 about systemic risk, I'm struggling with the
22 concept of further segregating out the end-user

1 business to just that business and talking about
2 not having margining on there, how that's going
3 to, you know, impact and create more systemic risk
4 or add to systemic risk. Under Dodd-Frank, you're
5 further segregating that business out. We have a
6 very robust credit risk management paradigm in the
7 end-user business that, you know, we talk about
8 from the Chesapeake perspective, from the Noble
9 perspective, from the rural utilities and the
10 co-ops, from the IOUs. We all have been doing
11 this for a lot of years. We allow a certain
12 amount of unsecured credit to be given and taken
13 through negotiations based on very dynamic and
14 robust analysis of people's credit profiles of
15 their business, their ratios, qualitative factors.
16 So, to try to come in with a one size fits
17 all-type situation for something that's been
18 working very well, that's a very small part of the
19 OTC market that is getting even smaller under
20 Dodd-Frank, to me just doesn't make a lot of
21 sense.
22 MR. HEIS: Jim Heis with Noble. In

1 addition to what Mark just said, you know, we're
2 all different. Some of us have strong balance
3 sheets. Noble doesn't post any cash collateral.
4 Other companies have to post non-cash collateral.
5 Smaller companies might have to execute through
6 the banks that they have their loans for. Right
7 now, you know, the posting of collateral is really
8 a credit issue, and the way it works right now is
9 that the counterparties agree up front before any
10 hedge transactions are ever engaged in, and the
11 system is working. You know, I hear AIG, Enron,
12 we're in a simple business. We need cash to drill
13 for energy. We don't do hedges or derivatives off
14 our hedges. We hedge one time, we take it to
15 settlement. So I think for what we're involved
16 in, this is a way too complex environment for what
17 we're involved in. And, you know, we think it's a
18 pretty -- it's hard to make money but it's pretty
19 simple as far as a business model.
20 Thanks.
21 MR. REILLEY: Bob Reilley. As regards
22 making swap dealers post collateral with

1 end-users, the first thing I point out is they
2 already do depending on the bilateral agreements
3 between the end- user and the swap dealer. Now,
4 beyond that I'm not sure that there is a good
5 reason as long as there is prudent credit policies
6 in place. And some of the other speakers have
7 referred to those. So I think may be a
8 requirement that best practices credit policies
9 are used would be less cumbersome and more
10 efficient than actually putting some sort of
11 collateral requirement in place.
12 MR. O'CONNOR: Sorry, just to clarify my
13 earlier point. The point is absolutely correct.
14 We have many bilateral collateral relationships
15 with end-users in place already. I was referring
16 to that first population I referred to at the
17 beginning of the clients that don't post any
18 margin at all and that's where the big numbers
19 start coming in as the dealers have to post out on
20 a one way basis.
21 MR. RADHAKRISHNAN: I'd like to know if
22 my colleagues from the Prudential Regulators have

1 any questions at this time.
2 MR. MACCHIAROLI: Just one question. I
3 wanted to pursue what Dan was saying about capital
4 load margin. How would you do that, Dan? We have
5 something like that built into the ANC rules now
6 where we look at particular -- but I'm just
7 curious what your --
8 MR. DRISCOLL: Well, as usual, I didn't
9 have anything specific in mind, Mike. But for FCM
10 capital requirements now, the exchanges all have
11 margin requirements for traders when they trade.
12 And if an account is under margin and that margin
13 call isn't met, then there's a capital charge
14 against the FCM. So you could have something in
15 place where if there was no margin at all posted
16 that some amount would be assessed through a
17 safety factor charge against a swap dealer's
18 capital for that amount. And it would have to be
19 determined what that proper amount would be and
20 what percentage in all that.
21 MR. MACCHIAROLI: Would that work, Mark?
22 MR. HOLLOWAY: That's what I was

1 thinking of but then picking up on what Steve said
2 and what Dan said and I believe the professor,
3 too, earlier. Far be it for us to write your
4 rules for you, but if the existing sets of rules
5 and the precedent of those rules persist. When we
6 salvage the rules for swap dealers and whatever,
7 there will be assessments exactly as Dan -- I
8 would expect that there would be assessments
9 exactly as Dan has outlined. As folks have
10 mentioned, if the collateralization is one way or
11 if in fact you just have unsecured credit, the
12 swap dealer would face a liquidity exposure. And
13 whether or not you assess that from a credit
14 charge point of view, the expectation would be
15 that you would look at it from a liquidity point
16 of view and somehow fact that into the capital
17 requirements that you would impose on the swap
18 dealer. But, yeah, I think what Dan is suggesting
19 is what I was kind of thinking about, too. Or
20 expecting I guess is a word to say.
21 MR. LEITNER: Just to make the point
22 that this is where symmetry in terms of how the

1 regulations are crafted by the SEC and the CFTC is
2 very important. So for that kind of, you know,
3 are you going to forbid any uncollateralized
4 exposures? I don't think that's necessarily
5 required but I think that there should be
6 appropriate costs to the dealer when that happens
7 and they should be the same regardless of which
8 regulatory regime we're operating in.
9 MR. RADHAKRISHNAN: Randall.
10 MR. DODD: Thank you. This is Randall
11 Dodd. Just a quick point. Again, something I
12 wasn't hearing and I thought it would be
13 worthwhile pointing out is that a lot of focus has
14 been on the cost to the nonfinancial end-user
15 trying to post cash or other liquid securities
16 margin combined with the assertion that, you know,
17 there's no problem here. The markets work just
18 fine. And of course it does then logically
19 follow, if there is no problem then this increased
20 cost would seem unnecessary. But it's premised on
21 your assumption that there is no potential problem
22 in the future.

1 And so what we need to think about is
2 whether indeed there is a potential problem here
3 and whether the use of collateral, of one method
4 or another, a line of credit or cash, could help
5 both prevent that problem and help eventually
6 price into the market that improves stability.
7 For example, if the market were to become less
8 liquid as it did in the earlier parts of the
9 2000s, that was a cost to you. And it was a cost
10 arising from the lack of adequate
11 collateralization previously. It took a while for
12 the market to recover and to reestablish itself.
13 And so if the market were now to move onto firmer
14 grounds because it was symmetrically
15 collateralized, then that improvement, too, should
16 be priced in. You should get more liquidity and
17 tighter bid-ask spreads, for example. And a more
18 resilient trading environment so that not just a
19 tighter bid-ask spread's day but even in the event
20 of turmoil or disruption it would be a tighter
21 bid-ask spread and more reliable liquidity.
22 And that benefit needs to be taken into

1 consideration because otherwise if you just assume
2 there's never going to be a problem, then you're
3 right. It's a slam dunk decision. But
4 considering the possibility of a problem, then you
5 get a more, I think, appropriate analysis of, you
6 know, the cost-benefit of this policy.
7 MR. RADHAKRISHNAN: Bill Wollman.
8 MR. WOLLMAN: I just wanted to go back
9 for a second on the capital in lieu of margin.
10 This ties very closely in my opinion to the
11 question on liquidity as well. If one of the
12 intentions of the Dodd-Frank Act is to reduce risk
13 and especially reduce concentration of risk, what
14 I would be concerned about is by allowing capital
15 charges in lieu of collecting margin, you're going
16 to force the business into a smaller group of
17 dealers and concentrate the risk instead of
18 spreading it among a wider group. And I think the
19 same thing holds with the liquidity as well. So I
20 could certainly see at the outset of a contract
21 where you're really dealing with potential future
22 exposure, I could see, you know, a mechanism for

1 calculating that and taking a charge in lieu of
2 collecting. But certainly as I think as the
3 contract goes on, these other factors need to be
4 considered because you could have the unintended
5 consequence of reducing the number of
6 counterparties instead of expanding it.
7 MR. CHAMBERS: Elliott Chambers,
8 Chesapeake Energy.
9 I agree with that. One of the things
10 that we do at Chesapeake, and I've heard this
11 around the table, is we spend a lot of time
12 thinking about how we control the risk that we
13 face with our counterparties. We do that, number
14 one, it's a bilateral arrangement that we have in
15 our multi-counterparty deal. They post to us cash
16 in certain scenarios where they owe us a
17 significant amount of money on their
18 market-to-market for the contracts. If you -- our
19 feeling is if you do require -- if you go to this
20 -- if you regulate this market too strictly, that
21 you're going to drive our counterparties out of
22 the market. And one of the things that we have in

1 our multi-counterparty deal is we have 13
2 counterparties. It's by design. We could have
3 set it up with five and probably gotten just as
4 much liquidity but we didn't want to do that
5 because we don't want to be exposed to any one
6 particular counterparty by that much. So we spent
7 a lot of time and effort to make sure that we
8 spread the risk around our counterparties.
9 Something that I'm sure other end-users around the
10 table can say the same.
11 MR. RAMSAY: Well, I thought, and Bill,
12 you correct me if I'm wrong, I thought Bill's
13 point perhaps was if capital is your solution --
14 if you take a capital charge in lieu of margin,
15 then it may be the only firms that can afford to
16 absorb that hit are, you know, five famous firms
17 that have been described in the legislative
18 history as, you know, comprising the bulk of the
19 market at this point.
20 MR. WOLLMAN: Yeah, John, that is my
21 concern because I think the pool of capital is
22 concentrated among some of the top-tier firms.

1 And there are others that have significant capital
2 as well. But if you start to allow people to take
3 charges, it becomes too uncompetitive, I believe.
4 MR. LEITNER: Can I just remind
5 everybody that Dodd-Frank -- this is Tony speaking
6 -- that throwing a bit of a monkey wrench into
7 this equation through the potential for
8 segregation. When you have segregation of
9 collateral, by definition it's not passing
10 through. And so it's not that, you know, so that
11 the market maker, the intermediary, who is trying
12 to provide, you know, two-sided markets, is coming
13 up, you know, the idea that, by the way, that
14 there are a lot of, you know, liquid assets even
15 in the most largest firms that can't be used or
16 deployed more effectively somewhere else than
17 putting up as collateral, I mean, there's not a
18 lot of, even in the biggest firms, a lot of free
19 stuff that can be posted out. So firms will
20 either increase the cost to the end user.
21 Now, you've got to fight with the
22 statute but the fact of the matter is that one of

1 the reasons why dealers, you know, try either not
2 to -- to make sure they get collateral and can use
3 it or price into the dealing relationship what
4 it's going to cost them to use that scarce
5 resource if they have to put collateral out the
6 other side, those are the things you've got to
7 worry about. What are the potential effects on
8 the dealer community for following through with
9 some of these initiatives.
10 MR. CORNELI: There's a lot of different
11 aspects of the whole scope of the industry that
12 we're talking about in response to your question
13 and I guess that's appropriate because you have to
14 deal with the whole scope. But I just want to go
15 to a point that Randall has raised several times
16 which is that as I hear it is the proposition that
17 in the end-user community, those of us who are
18 posting non-cash collateral should somehow be
19 required to also post margin on top of that and
20 that we should be happy to do that because it will
21 somehow reduce bid-ask spreads in our hedging
22 products. I think that's flawed logic in a number

1 of ways and some of it has been said. But one
2 thing that hasn't been said yet is that our
3 counterparties do not like to take risks with us
4 and therefore impose on these first lien assets
5 what is called a right way risk constraint which
6 means that basically, you know, hedges that --
7 where our insolvency presents a risk to them, the
8 positions that would lead to that increase the
9 value of the assets. And I imagine this is the
10 same for Chesapeake as it is for us and others --
11 increase the value of the assets that we're using
12 as collateral and make -- because the increase in
13 value can be really remarkable, like when the
14 price of gas goes up if you've sold gas and your
15 exposure is to low gas prices. There is a great
16 deal of high quality collateral. It may not be
17 the sort of thing you can liquidate today but it
18 is the sort of thing that any asset market would
19 recognize and be able to provide funds against in
20 a fairly quick order.
21 So I think -- I think the key here from
22 the end- user perspective is don't make us

1 collateralize our counterparties' trades twice and
2 don't make them collateralize their trades with us
3 twice because if there's enough, there's enough.
4 And if there isn't enough you better, you know,
5 let's look for the factual basis of it rather than
6 speculating about how this little two percent tail
7 of the market might cause some sort of massive
8 financial problem like the one we all regrettably
9 lived through over the last several years. And,
10 you know, that I think is the end-user piece.
11 I think the other piece of this, what
12 I'm hearing is kind of a similar theme from the
13 financial community here -- is there are practices
14 that adequately collateralize complex trade
15 exposures, and those should also be recognized by
16 you. And I think those kind of common sense
17 guidelines seem to me to make a lot of sense as
18 you carry out your mission.
19 MR. RADHAKRISHNAN: We need to move to
20 swap dealers. So, you know, let's assume that the
21 transaction is between two swap dealers. I think
22 the statute is pretty clear. We have to impose

1 initial and variation margin requirements. So how
2 do we do it?
3 MR. O'CONNOR: I'm sorry. Is the
4 statute clear as to initial margin between swap
5 dealers?
6 MR. RADHAKRISHNAN: I believe it is.
7 Let's assume it is. I'm sure when we put it up
8 for comment you might disagree, but I think it is.
9 MR. O'CONNOR: Right. So this is
10 another interesting area I was going to raise
11 essentially if you didn't, but having clarity on
12 that would be beneficial for the market. I think
13 that's certainly our impression was the statute is
14 clear as to initial margin being required in
15 dealer to client transactions, other than for
16 those end- users that are exempt. But in the
17 dealer-to-dealer case, I think that there are some
18 dangers there in the sense that if dealers -- if
19 dealer-to-dealer -- he's got the statute there --
20 if dealer-to-dealer --
21 MR. RADHAKRISHNAN: Let me just read it.
22 SPEAKER: Okay.

1 MR. RADHAKRISHNAN: It says, and I'm
2 paraphrasing, Commission, meaning us, shall adopt
3 rules for swap dealers and major swap participants
4 with respect to the activities as a swap dealer or
5 major swap participant for which there is not a
6 Prudential Regulator imposing capital requirements
7 and both initial and variation margin requirements
8 on all swaps that are not cleared by a registered
9 DCO.
10 MR. O'CONNOR: Right. So there is, I
11 guess, a consequence of that is that liquidity is
12 taken out of the system as it would have been with
13 the one way out activity we talked about earlier.
14 And we have done some analysis of that and the
15 amount of margin we won't have to collect from
16 dealers is between $50 and $100 billion. Now, to
17 the degree we were doing the same on the other
18 side, that's the kind of numbers we're talking
19 about. That's the number withstanding. So again,
20 across the street it's multiples of that and gets
21 into very large numbers.
22 I would imagine that if it's left up to

1 dealers to ask for segregation, which is
2 contemplated in the statute and they chose not to,
3 then that moving of collateral around doesn't
4 really mean anything in the sense I'm from the
5 same guy I'm calling $50 billion or $10 billion if
6 it's, you know, I'm giving him the same number and
7 it's a wash. So that has no systemic protective
8 consequences as far as I can tell, and in fact,
9 introduces a hazard in the sense that if one party
10 in that relationship begins to deteriorate from a
11 credit point of view, it's likely that his partner
12 might say, well, actually now I'd like you to
13 segregate that. And that causes a huge liquidity
14 drain right at the time, you know, it's almost
15 impossible to meet that demand.
16 So I'm not sure whether the choice as to
17 whether to segregate or not is a good thing to
18 leave out there. Assuming that choice is not on
19 the table and margin has to be segregated, again,
20 there's a huge, you know, dealers would have to
21 raise money often equal to the amount of the debt
22 they have outstanding, again, in the capital

1 market. So that puts a massive stress on the
2 system and again takes money out of the economy
3 and puts it into a lockbox at a custodian
4 somewhere. So there are huge unintended
5 consequences of that. Now, clearing, clearly, if
6 we clear to the max that alleviates that but there
7 will still be an uncleared population that is
8 captured.
9 MR. RADHAKRISHNAN: So Steve's point is
10 don't do it but how about if somebody tells us how
11 do we do it. Let's say we've got to do it. And I
12 respect that point. But let's say we have no
13 choice. And let's say because the statute says
14 you've got to do it, how do you do it?
15 MR. DODD: Well, I'll take a stab. I
16 think one is to look at some of the mistakes we
17 made in the past by not doing it. Collateral
18 should be a high quality and liquid and not,
19 particularly with dealers, illiquid. Collateral
20 needs to be adequate to address expected losses.
21 It should be done on a portfolio basis, not on a
22 kind of portfolio invariant additive basis that we

1 had with Basel I and those problems but with a
2 portfolio basis. And then you look at, you know,
3 the value at risk of the portfolio. What's the,
4 you know, the same we do with the initial margin
5 now on many of the exchanges, they look at the
6 potential for that price to move and the initial
7 margin there from the beginning.
8 Now, with the dealers you've got an
9 exchange of initial margin that may net out to
10 zero, but that's therefore not a cost to you but
11 still provides the stability service because it
12 gives them additional incentives to maintain a
13 balanced book and a balanced credit exposure
14 across their other dealer counterparties. Right?
15 So you do that now. You have swap meets regularly
16 to managed that and you do things but this gives
17 you more incentives to maintain that as close to
18 home as you can. Right? And if you succeeded at
19 that then it wouldn't be a problem. And even
20 before there was a comment made about segregated
21 accounts. I hope people don't have the impression
22 that money goes into a segregated account and it

1 stays there. That's not how that works. In a
2 clearing arrangement and exchange you put your
3 money through the segregated account into the
4 exchange clearing house. You lose money. That
5 money goes out. It doesn't stay there until you
6 trade out of your position. So that money isn't
7 inert. It isn't idle. It is very critical into
8 providing the funds to flow into the margin --
9 segregated margin account of the winners of the
10 transaction.
11 So segregated accounts just means that
12 it's bankruptcy removed from the FCM and it
13 prevents Lehman-type of problems in the event of
14 bankruptcy. So if the dealers are now, by
15 positing the initial margin based on expected
16 loses of their portfolio derivatives positions,
17 then you know, you would be -- and if it kept
18 their book close to home, meaning delta neutral or
19 maybe even a gamma such that it's delta neutral
20 over multiple days, then -- and then they also
21 keep the credit exposure level across their major
22 dealer counterparties, then there's not much of a

1 cost here. Right? And so I don't see why this is
2 a trillion dollar cost to them.
3 MR. O'CONNOR: Okay. So just picking up
4 on a couple of points there. I think I agree with
5 you. There's no cost if there's no segregation.
6 But if there's no segregation but one party has or
7 both parties have the right to pull that trigger
8 at any point, that creates convexity right at the
9 wrong time from, you know, from a credit
10 deterioration point of the wounded party.
11 Now, we do generally run flat books.
12 However, a typical -- it's almost impossible to
13 run a flat book in the dealer-to-dealer market,
14 which is an important part of the market
15 structure. So take the example where I do a trade
16 with one of the oil companies around this table
17 and to offset that I don't have a natural end-user
18 to do it but Mark has one on the other side. Then
19 I will lay my risk off with Goldman Sachs and they
20 will do a trade with their client. I'm close to
21 home. I've got a flat book. I'm doing the right
22 thing, especially in the Volcker-era, not taking a

1 huge market risk position there but on that
2 dealer-to-dealer trade I might have a huge risk,
3 which is -- would drive -- and the numbers I threw
4 out earlier were based on a portfolio, sort of our
5 style approach. We assume the market will be able
6 to get its arms around that pretty easily. But
7 still, there won't be, because of the nature of
8 market making, there won't be the opportunity to
9 keep those dealer-to-dealer portfolios flat.
10 MR. LEITNER: By the way, just, I may be
11 the one guilty for creating the confusion about
12 segregation. What I was talking about was if in
13 the over-the-counter context you have triparties,
14 that's the kind of collateral that gets stuck.
15 MR. DODD: If I could just respond
16 briefly. Morgan Stanley's derivatives portfolio
17 with Goldman is probably $5 trillion. And so if
18 you just look at two trades it looks hard to keep
19 it close to home in terms of your counter --
20 current credit exposure with your counterparties.
21 But if you take the whole derivatives portfolio,
22 over $5 trillion worth of transactions, you know,

1 that's a lot more fluid and a lot more flexible.
2 So you may be imbalanced with energy but you may
3 be imbalanced or you could become imbalanced in an
4 opposite way with the equity or currency or
5 something else. So the possibilities for doing
6 that I think are much greater than that pure kind
7 of commodity.
8 MR. O'CONNOR: Yeah, I agree. Sorry, we
9 were talking in the conversation here. I agree
10 that over, you know, a large portfolio and across
11 many asset classes when hopefully we can get a lot
12 of these under the same legal netting agreement
13 between asset classes. You get enormous
14 diversification benefits. However, trying to
15 manage the VaR in a dealer-to-dealer portfolio is
16 very -- I've tried to do it. It's very, very
17 hard, particularly when you have cleared trade,
18 you have exchange trader trades, and you have
19 end-user uncleared and dealer uncleared trades in
20 the same risk portfolio. It's almost impossible
21 to move the dial if the specific intent or the
22 only intent of a trade is to move the dial on that

1 portfolio. The risk is what it is typically.
2 MR. NICHOLAS: John Nicholas, Newedge.
3 I think dealers can manage risk in a number of
4 ways that we've talked about obviously.
5 Offsetting swaps, for example, is one of the ways.
6 A matchbook, if you will. Collecting margin is
7 another way. But one of the other ways I think
8 that a dealer will often look to manage risk is to
9 establish essentially an economically neutral
10 proprietary hedge in the securities or the futures
11 markets. And I think that it's important to take
12 into account that in certain circumstances firms
13 are required to take a substantial or even
14 complete haircut in the future or the securities
15 side, and I think that this is keeping certain
16 firms out of the swap arena, if you will, which is
17 not consistent with Dodd-Frank. I think
18 Dodd-Frank wants an open market with as many
19 participants as possible. So I would just urge
20 the commissions to consider, you know, when you do
21 have a proprietary hedge on the exchange side that
22 it receives some haircut relief versus the

1 over-the-counter swap.
2 MR. HOLLOWAY: Mark Holloway from
3 Goldman Sachs. Responding to John Ramsay's
4 request for suggestions, there may be a precedent
5 in the rules today that is a useful precedent in
6 this context. That is within the SEC's rules we
7 have one segregation requirement for our customer
8 base as that term is defined in the rules and
9 another segregation requirement similar but with
10 some important differences for the broker-dealer
11 community. And I think that the suggestion would
12 be to consider some types of flexibility when you
13 structure the segregation requirements for swap
14 dealers and security-based swap dealers in the
15 future, there's a tendency I think for some people
16 in the broker-dealer community to think that the
17 SEC requirement for swap dealers is likely to be
18 very, very similar to what is currently in place
19 in the futures world. Steve and others have
20 raised some comments about how that could be very
21 problematic depending on how margin flowed and who
22 decided to what. But I think there may be some

1 flexibility just exemplified in the differences
2 between those two segregation requirements that
3 possibly would be useful here. We've got a lot of
4 different variables that we've mentioned today in
5 terms of nature of counterpart and so on and so
6 forth, but it may be worth a look.
7 MR. RADHAKRISHNAN: We also have to
8 promulgate requirements with respect to variation
9 margins. Any thoughts as to how we should do it?
10 (No response)
11 MR. RADHAKRISHNAN: No thoughts
12 whatsoever?
13 MR. O'CONNOR: Well, no, I think there's
14 been a lot of focus on this recently at ISDA, and
15 ISDA has a group working with the Global
16 Supervisors Group to improve bilateral collateral
17 margin arrangements in the area of dispute
18 resolution. So, it's very important.
19 I think that the market though,
20 certainly from my point of view, is generally in a
21 good place in that the bilateral arrangements
22 you've been hearing about, parties exchange

1 valuations daily, and there are best practice
2 standards that call for daily variation margin to
3 be moved, which just spending a second on that,
4 what happens there is that the portfolios are
5 valued every day using a combination of inputs and
6 models, and I think parties typically have evolved
7 to the state whereas disputes between trade
8 valuations are a fraction of what they were years
9 ago, and there are now better mechanisms for
10 dealing with disputes between those valuations.
11 So, the portfolios are valued every day
12 compared to thresholds. Any exposure that is not
13 covered by margin on that day will result in a
14 call or a return of margin, and I think, in
15 general, the process seems to work quite well.
16 And in terms of how and what extra rules you would
17 impose, I think one thing to do might be to ask
18 for submission by ISDA, for instance, to lay out
19 the best practices and build something around
20 that.
21 MR. LEITNER: Steve's actually reminded
22 me that there are two fundamental ways that you

1 can approach the regulation on both of these
2 topics. They're not mutually exclusive, but they
3 are different. Qualitative or quantitative. Are
4 you going to impose numbers or are you going to
5 provide for flexibility based upon meeting
6 criteria?
7 The SEC has some experience in doing
8 that with the OTC derivatives dealer that was kind
9 of a unique animal, but the permission for a firm
10 to establish one of those was based on meeting a
11 number of criteria. Do you have adequate models;
12 do you have adequate risk management practices in
13 place? All the things you do based upon the
14 conclusion that ultimately you were providing a
15 financial intermediation role as well as a market
16 intermediation role, and, therefore, you could
17 take on secured credit, but the haircut was based
18 on your evaluation of the counterparties, so, you
19 had be able to group credit counterparties, and,
20 in that case, you could have some flexibility in
21 terms of whether and how much initial or variation
22 margin you took. I think that approach makes a

1 lot of sense, but it's one way to do it, and it's
2 potentially preferable to one size fits all
3 numeric requirements.
4 MR. WOLLMAN: The only counter-argument
5 to the one size fits all is one size fits all is
6 predictable, and I believe that Steve mentioned it
7 before, that just when you need the
8 collateralization when somebody's credit
9 deteriorating is the least likely time when they
10 can collateralize their exposure. So, that
11 precipitates problems, and it's also unpredictable
12 even if they can because the users of these things
13 have other commitments, and if they can't predict
14 what their margin is going to be, because there
15 could be a change in the methodology used by the
16 dealer whether to evaluate whether to collect or
17 not, it just could be problematic due to the
18 unpredictability.
19 And the other issue that Tony raised
20 about the derivatives dealers, my only concern is
21 that the derivatives dealer was really segregated
22 from any other clients. It was all derivatives

1 counterparties, and as we mentioned before, there
2 may be, depending on how some of the capital and
3 other rules flow out of this, a consolidation of
4 this business into entities that have significant
5 exposure to futures customers and securities
6 customers who have nothing to do with this
7 business, and my fear is that you reduce investor
8 protection by leaving that uncollateralized
9 exposure. So, I know it's not the popular view.
10 MR. DRISCOLL: So, I'm a firm believer
11 in that some of the best regulations that have
12 ever been written have been done by finding out
13 what the best practices are in the particular
14 industry and basically making those into rules of
15 some sort. And the two ways to do that are to
16 have one model or to allow different models, but
17 with certain standards that would be enforceable.
18 So, best practices are great, but when push comes
19 to shove, you have to be able to enforce those,
20 and, so, that if you could come up with particular
21 traits, particular things that would have to be
22 taken into consideration in determining what the

1 marks are, what the margins are, I think that
2 could work, and perhaps over time what would
3 happen is that the industry would find it more
4 effective for business purposes to try to come
5 together and perhaps not have 20 different models,
6 but to have one consistent one.
7 MR. RAMSAY: I guess that sort of begs
8 the question, is that practical for this
9 particular kind of business, and certainly, there
10 are more standardized kinds of models that have
11 been used for certain kinds of positions, and it
12 doesn't mean that new things can't be developed
13 that could.
14 A separate question, I guess, is is
15 there something that can be reliable enough at
16 this point that we could rely on? I mean, I guess
17 when you're talking about some of anticipates or
18 jumps ahead a little bit into the discussion that
19 we're going to get into in the second half on
20 capital, but, arguably, if you rely on firm
21 proprietary models for capital purposes, then,
22 arguably, you ought to be able to rely on them for

1 margin purposes, as well. Maybe plus some sort of
2 safety factor. Does that create some kind of
3 competitive issue?
4 It seems like a lot of these questions
5 sort of draw back to what kind of competitive
6 environment are we creating because if you allow
7 firm proprietary models to work for all of these
8 purpose, there's probably a relatively small
9 circle of firms that are going to be able to model
10 an appropriate degree of sophistication, arguably,
11 unless, again, you allow something that's more
12 sort of standardized. Yes.
13 MR. RADHAKRISHNAN: Yes?
14 MR. DODD: This is Randall. Let me
15 address that concern with the capability in that
16 I've met with the leaders of TriOptima, and
17 they've got a software that they claim to me has
18 been adopted by 98 percent of the industry, but
19 which they're already used to face off against
20 each other at the end of each day to calculate
21 variation margin. All right. And, so, in that
22 sense, that's as complicated a problem as using a

1 portfolio margin in like SPAN to calculate an
2 initial margin. But after the end of the day,
3 once market prices have been established, in most
4 instances, then this product, which is already
5 being used throughout the industry, is apparently
6 already quite effective in handling the variation
7 margin. And, so, that's what you might consider a
8 best practice now, but I thought it's worthwhile
9 adding the point that you want to make sure that
10 best practices are also an adequate practice, and
11 this sounds like a good example where it would be,
12 but, also, you've got to think about when the
13 actual variation margin payment is made.
14 One of the problems we've had in
15 clearinghouses is they didn't have automatic
16 payment mechanisms, and one participant would
17 delay their payment in, and that would cause a
18 crisis at the clearinghouse. This was as recently
19 as 1987. And, so, now they've gone to automatic
20 payment systems where you know the payment's
21 coming in by 10:00 a.m., and, so, you can net out
22 and transfer. And, so, again, depending on what

1 ISDA comes up with, that might be something you
2 want to require as opposed to you merely want to
3 advise that these daily payments are made
4 automatic in a way that the dealers can rely on
5 the inflows to meet their outflows, because,
6 otherwise, there's a credit-payment mismatch, and
7 there's a serious potential problem there.
8 Pardon me if I misunderstood you, but it
9 seemed also sometimes the discussion got a little
10 bit confused between whether we're now talking
11 just about variation margin or initial margin, and
12 the initial margin I think is the one that's more
13 operationally challenging because of the need to
14 rely on SPAN or some other portfolio margining
15 calculation and whether we need to either go to a
16 single model that everyone could adopt and use or
17 whether we're going to rely on individual firm's
18 model, and if we rely on individual firm's models,
19 what the guidelines are going to be about the use
20 of past data, about whether it's weighted equally,
21 whether these initial margin requirements will
22 have seasonal factors to concern themselves with,

1 whether they're going to concern themselves with,
2 where the market is at because we've had a boom
3 for the last year or has it traded flat, and
4 whether it's going to include these kind of
5 factors and that we haven't had to deal with as
6 regulators in the past. We've had a rather simple
7 approach, I think, in the past to setting margin,
8 and once we start dealing with OTC, retaining OTC
9 positions that aren't always liquid, then it
10 becomes a much more challenging task to set the
11 guidelines on which either the common or the
12 individual models are going to have to meet in
13 order to pull that off.
14 So, pardon me if I've gotten ahead of
15 you, but I just wanted to throw that out there
16 before we leave the point.
17 MR. O'CONNOR: Sorry, yes, so, just to a
18 point on the models, I think it would be quite a
19 challenge to deploy kind of industry standard
20 evaluation models into the system. And from a
21 pragmatic point of view, you'd only really be able
22 to do that for sort of vanilla liquid stuff, and

1 that's not where the disputes arise. So, it's
2 quite in what you're trying to achieve.
3 Just for clarification, the TriOptima
4 thing mentioned earlier, that's not a valuation
5 model, that's where dealers used their own models
6 and then send in valuations on a trade-by-trade
7 basis, and it's a good system and we use it, but
8 it doesn't value the trades. It's an automatic
9 upload of trade valuations, and then it comes back
10 and tells you okay, with this dealer, you've got
11 these differences or with this client, you've got
12 those differences. There's no algorithmic
13 valuation in there, it's just a comparison tool.
14 MR. RADHAKRISHNAN: I want to ask a
15 question about the use of non-cash collateral.
16 The statute directs the regulators to permit the
17 use of non-cash collateral. But it has to be
18 consistent with preserving the financial integrity
19 of the markets trading swaps and preserving the
20 stability of the United States financial system.
21 Any guidance as to what types of collateral the
22 regulators should permit given those objectives

1 that are in the statute? Should it cash and
2 treasuries and nothing else? Should it leases of
3 gas and oil and so on?
4 MR. CHAMBERS: This is Elliot Chambers,
5 Chesapeake Energy. Going back to our multi
6 counterparty deal, it is in the form of
7 (inaudible) properties, as you mentioned, and we
8 think it works fine.
9 With respect to the representative from
10 NRG, we feel that the way we've set it up is the
11 right way risk model, meaning that if a trade that
12 we have on an OTC derivative goes against us by
13 $1, relationally, the collateral we've posted will
14 go up by $1 so that they're moving in lockstep
15 upwards. We think that model works fine. I'm
16 speaking solely for the energy industry, where we
17 have that benefit of the collateral matching the
18 underlying OTC contract. I'm not sure what to do
19 with other end users that don't have access to
20 that type of collateral.
21 MR. CORNELI: And I'll just say that the
22 easy way to comply with that, although it's not

1 only the partial way, is through the end user
2 exemption and you don't have to actually do it
3 because you just let us keeping doing it, and that
4 works very nicely, and it's an incredibly easy and
5 efficient solution that complies with the law in
6 part. Now, I think the law is also about where
7 for trades outside of the end user exemption, you
8 should also allow non-cash collateral, and I think
9 that is a tougher nut to crack because the reason
10 it works so nicely in the OTC market is because
11 it's not something that any counterparty will do
12 with any other counterparty; it's something that
13 satisfies, given the nature of the transactions,
14 the web of transactions that are in the whole
15 value chain, and the awareness of the
16 counterparties, it works for counterparty A
17 against counterparty B's oil and gas assets or
18 power plants or whatever asset to actually provide
19 this right way risk collateral. So, I think that
20 it's a great question. I think the trick, and
21 maybe other people have better ideas about this
22 than I do, is to figure out how to minimize the

1 transaction costs associated with taking it out of
2 that naturally efficient transaction environment
3 and putting it a more centralized environment.
4 MR. RADHAKRISHNAN: Yes?
5 MR. TOURANGEAU: Mark Tourangeau. I
6 just wanted to add to that that I think I've read
7 somewhere that there is the thought that first
8 liens would be kind of one size fits all for
9 energy, and I want to second I think what Mr.
10 Wasson said that that is not allowed in certain
11 areas of the utility practice due to the
12 regulatory environment or even in the non-regulatd
13 area. Those liens may already have been granted
14 via financing or a financing hedging structure,
15 and, so, I just want to make sure that when we
16 talk about non-cash collateral, it should not be
17 prescriptive; it should be based on, again, the
18 best practices already established in the industry
19 for a wide range of high-quality assets.
20 MR. O'CONNOR: A quick dealer
21 perspective on that. I think that (inaudible) of
22 the policies and procedures and prudent risk

1 management and within that context, I think
2 flexibility should be provided for, and,
3 therefore, I think coal in the ground or oil under
4 the sea of buildings with the appropriate legal
5 due diligence and the appropriate haircut and
6 considerations as to whether those collaterals are
7 the right way or the wrong way, vis-à-vis the
8 portfolios under consideration, I think if you can
9 get through all of that then those types of assets
10 are valid collateral in the use in the market
11 today and there should be a place for them going
12 forward.
13 MR. LEITNER: Just from what I'm
14 hearing, it looks like the differences to draw the
15 distinction between the functional equivalent of
16 cover, like I'm (inaudible) against the box. I
17 already own something, and I'm creating a pure
18 hedge against it, that's the easier issue to deal
19 with than illiquid collateral when it's not of the
20 same asset class as what you're dealing with. So,
21 I like the idea of looking to best practices in
22 those communities where the hedging is, in fact,

1 an end user type hedge, and trying to validate
2 them so you can get on with the tougher questions.
3 MR. RAMSAY: Before we leave the topic
4 altogether, and now we've gotten the end users
5 sort of back in the discussion, there was a
6 question that I wanted to raise that all of this
7 sort of a question raises for me, which is
8 Dodd-Frank generally, we think, calls on the
9 regulators to encourage cleared business,
10 migration of business to a cleared environment to
11 the extent possible. What I'm hearing from a lot
12 of the end user community, at least represented
13 here, is that, obviously, in a cleared
14 environment, margins can be posted one way or
15 another by definition, it has to be, and, so, what
16 I'm hearing in terms of the evolution of the
17 market, what I'm hearing from the end users
18 represented here is that, tell me if I'm wrong,
19 the expectation is that they would expect to
20 continue to clear a large portion, the bulk of
21 their trades in an un-cleared basis, and maybe
22 that calculation depends on how the cleared market

1 develops, but I'm interested in any sort of
2 general thoughts about that.
3 MR. WASSON: Russ Wasson with the
4 National Rural Electric Cooperative Association.
5 For about the past 15 or 20 years, the Committee
6 of Chief Risk Officers for the energy industry has
7 been developing very robust and flexible
8 principles-based risk management practices, and
9 those practices have served us exceptionally well.
10 The energy industry has tremendous numbers of
11 transactions, and we believe that those
12 principles-based risk management practices are the
13 way that you should go and look at end users
14 particularly in the energy industry because, from
15 our point of view, if it's not broken, you don't
16 need to fix it.
17 MR. TOURANGEAU: And, actually, to be
18 clear, there are segments of our business that
19 rely almost exclusively on cleared or exchanged
20 markets at NextEra, and then there are other
21 segments that rely almost exclusively on the OTC
22 markets, given the fact that we can get unsecured

1 credit lines from different dealers in order to do
2 our hedging. So, when we go out as an end user to
3 a hedge for our natural gas needs, because Florida
4 Power and Light is one of the largest burners of
5 natural gas in the country, we are taking
6 advantage of those unsecured credit lines because
7 that affords us the best prices in the marketplace
8 which then get passed on to our customers. So,
9 losing that would be a cost that would then be
10 incurred back to our customers at the utility
11 level.
12 MR. CORNELI: In our company, we have a
13 first lien facility conceptually very similar, I
14 think, to Mr. Wasson's companies that we use for
15 hedging about 80 percent of our base load power
16 production. Almost everything else that we hedge,
17 which is significant, we hedge on an exchange
18 cleared basis, and we don't anticipate there being
19 any change in that, any desired changes in that,
20 or really any even feasible changes in that under
21 Dodd-Frank, assuming that the end user exemption
22 works the way that we've basically discussed here

1 and that we understand the structure of Dodd-Frank
2 to call for and permit.
3 MR. HEIS: And just to be clear, Noble
4 Energy, we clear nothing. We transact 100 percent
5 of our hedges in the OTC market. They're all with
6 the banks and our credit facility, and we do no
7 speculative or proprietary trading. Every
8 transaction we do is a pure hedge.
9 MR. WOODARD: And, again, just from
10 another end user, again, Williams is a large
11 natural gas producer. I think we're similar to
12 most around the table here. We use the clearing
13 market for a large, large percentage of our trades
14 right now. Again, it's just specific facilities
15 we have set up for our production and to limit
16 risk as far as netting and offsetting credit with
17 our physical business that we do OTC, and I don't
18 see that changing.
19 MR. RADHAKRISHNAN: All right. Well,
20 thank you very much. We've got to come to an end
21 to this portion of the panel discussion. It was
22 very spirited, and I really appreciate all of your

1 observations and comments and contributions. I'm
2 going to take a break, 15 minutes. There's a
3 clock back there. So, let's be back at 3:15.
4 We'll start off with the next panel for capital.
5 Thank you very much.
6 (Recess)
7 MR. RAMSAY: All right, so, we'll have a
8 more intimate discussion group for the second half
9 dealing with issues involving capital and capital
10 requirements for swap dealers and securities-based
11 swap dealers. I guess as we did before, if maybe
12 it would make sense to go around the table and if
13 people could introduce yourself and which firm
14 you're with, say starting at this end.
15 MR. MATTONE: Ralph Mattone, Nomura
16 Securities.
17 MR. REILLEY: Bob Reilley for Shell
18 Trading.
19 MR. GILLIS: Tom Gillis, Newedge USA.
20 MR. SILVA: Ralph Silva, Goldman Sachs.
21 MR. DODD: Randall Dodd, former CFTC
22 staff and former Financial Policy Forum.

1 MR. VISWANATHAN: Vish Viswanathan, Duke
2 University.
3 MR. TOURANGEAU: Mark Tourangeau,
4 NextEra Energy.
5 MR. NEWMAN: Tim Newman with Williams.
6 MR. DRISCOLL: I'm Dan Driscoll from
7 National Futures Association.
8 MR. COLLINS: Jim Collins, JP Morgan.
9 MS. DIAZ: Thelma Diaz, CFTC.
10 MR. SMITH: Tom Smith, CFTC.
11 MS. SCHWADRON: Margot Schwadron, OCC.
12 MS. REA: Laurie Rea, Farm Credit
13 Administration.
14 MR. FRENCH: George French, FDIC.
15 MR. HEMPHILL: Mike Hemphill, Federal
16 Housing Finance Administration.
17 MR. LYNCH: David Lynch, Federal Reserve
18 Board.
19 MR. RAMSAY: So, I guess maybe it would
20 make sense to kick off the discussion sort of
21 taking over from where we left off with the
22 discussion of margin and talking about the

1 modeling of capital in this case, and I guess I'll
2 start off at just sort of a simple level, which is
3 one could question the extent to which regulators
4 ought to rely on models for this business or the
5 extent to which or how heavily to rely either
6 because of concerns about the performance of firm
7 models or the ability to deal with the financial
8 crisis or for other reasons or perhaps just
9 because of questions about the practical ability
10 to oversee the performance of models and monitor
11 their performance just in a supervisory sense and
12 the resources that that might require. If you
13 don't permit firms to model, then I suppose you
14 have to have some kind of alternative, which would
15 traditionally at least in the -- pardon me?
16 MS. DIAZ: Oh, I'm sorry.
17 MR. RAMSAY: Sorry. Traditionally, the
18 SEC's net capital at least has imposed pretty
19 heavy haircuts for these kinds of positions, which
20 means that it's been practically difficult or
21 impossible to do the business through a regulated
22 entity. So, I guess I'll start off there, either

1 with people who have a particular stake or with
2 particular firms on how both the extent to which
3 why regulators ought to feel comfortable, if they
4 should with firms' ability to model this business,
5 and are there any alternatives that would make
6 sense?
7 MR. COLLINS: It's Jim Collins from JP
8 Morgan. I'd just make a few comments on the
9 models and where we see them to be effective,
10 certainly as opposed to standard haircuts.
11 I think the view, if you look at the
12 models, is that they are much more effective at
13 recognizing hedges for capital purposes than
14 standard haircut rules are, and actually provides
15 an incentive for firms to hedge. You put a
16 position on, you hedge it, you're going to get a
17 lower capital requirement than a standard haircut
18 or a grid-like approach might give you. So, I
19 think that certainly points to benefits and
20 models.
21 And, also, another point to make is that
22 as we're going along and there's going to be more

1 reporting on derivatives going forward, I think
2 it's going to provide a lot more price
3 transparency for derivatives, which will be better
4 for models overall, and their ability to
5 adequately account for risk.
6 So, certainly, those are a couple of
7 benefits for models. And you have to remember
8 also when you use models, often or at least in the
9 rules that we've applied, whether it be Appendix E
10 of the FCC's net capital rule, also known as the
11 alternative net capital rule, it's not just models
12 alone, it's what you do with it. Do you have
13 add-ons, specific risk add-ons or other types of
14 add-ons that are mandated by a regulator on top of
15 that, on top of just what the model provides you?
16 It tends to be, we feel, a better approach to
17 overall risk and capital than just taking a
18 standard haircut type of charge.
19 MR. MATTONE: Hi, Ralph Mattone, Nomura.
20 I have to agree with Jim that the modeling does
21 make a little more sense because some of the
22 entities that we have right now that we do apply

1 the models, and if we were to apply standard
2 haircuts, it would almost make it prohibitive to
3 be in that business because of the volume that we
4 do and so forth like that. And our credit
5 department does rely on these models to make sure
6 that the counterparty credit exposures within
7 certain limits and certain guidelines that we have
8 set, I think models is the way to go.
9 MR. RAMSAY: I'm sorry.
10 MR. DODD: Yes, the other part of your
11 question, I thought, was how would you monitor the
12 performance of the models, if I'm not mistaken,
13 and I just wanted to suggest there are some
14 examples with the SEC with your own broker-dealer
15 lite rules, where you back test the model and you
16 look at how it's performed in the past and make
17 adjustments and penalties if there's been errors.
18 But I wanted to also throw out one
19 experience I had from looking how other countries
20 handled some of these problems is that in the case
21 of Chile, for example, the government produced its
22 own model and gave it away, and then they update

1 it, and, so, what this creates for many firms is a
2 minimum standard for the quality of your
3 evaluation models because at least the smaller
4 firms will take something for free that they know
5 the government will agree with, right? And then
6 if you want to exceed that with your own private
7 model that you say is better, then you have to
8 look at back testing and other ways in order to
9 monitor it.
10 So, that's one way to go about it. That
11 you could, in that sense, get part of the market
12 with the standard model because it would be the
13 done that would have the price to manage.
14 MR. RAMSAY: Yes?
15 MR. DRISCOLL: Dan Driscoll from NFA.
16 One point I'd like to make, and I'm not opposed to
17 the use of models, at least to a certain extent,
18 in the area of capital, one reason the haircuts
19 under both CFTC and SEC rules don't necessarily
20 work, that precisely in some areas now is those
21 haircuts have been on the books for years and
22 years, sometimes before even these products were

1 actually traded. So, I do think that to the
2 extent that haircuts are necessary here, perhaps
3 it's a good time to take a look at some of those
4 haircuts and try to determine if they're really
5 commensurate with the risk.
6 MR. VISWANATHAN: Yes, I want to kind of
7 chime in with Randall a little bit on this. I
8 think it would be a mistake to have
9 non-standardized models over long periods of time.
10 I think many of these models are well understood
11 with the Wall Street community; there'd only be
12 difference across firms. Probably there should be
13 a process like open (inaudible) software where a
14 standard model is accepted, back tested, and, over
15 time, if there are changes, a new model is used.
16 I think it's important for the regulatory to be
17 involved and to some extent at least in
18 understanding what models are used and what the
19 implications are because, in the end, models are
20 not markets, and we know that, at times, they can
21 make mistakes. So, it's important to understand.
22 MR. RAMSAY: I think some of the

1 comments people just made sort of raises the
2 question more distinctly about when we talk about
3 models, are we talking about individual firm
4 proprietary models versus things that are more
5 standardized. And it probably depends on what
6 kind of business you're talking about, right?
7 We've got what we refer to as the alternative net
8 capital firms, who are doing a large range of
9 business, and to the extent that swaps and
10 securities based swaps business might be done in
11 the same entity, and, presumably, those
12 proprietary models might be able to take account
13 of that, as well.
14 From a regulatory perspective, and we're
15 used to looking at those, regulatory perspective,
16 I guess, we don't know who's likely to come in the
17 door once all of these various rules are adopted,
18 and, so, if anybody has any intelligence on who's
19 likely to come in the door, it might be
20 interesting to know, but I guess beyond that, it
21 is what's the practicality of relying on more
22 standardized sorts of models for people who may

1 come in looking to focus on this particular
2 business? If anybody has any follow-up thoughts
3 on that.
4 MR. TOURANGEAU: Well, are you talking
5 about when someone comes in the door -- sorry,
6 Mark Tourangeau -- as in a non-financial swap
7 dealer that gets designated under Dodd-Frank as a
8 swap dealer?
9 MR. HEIS: Well, you say
10 "non-financial." I'm basically saying anybody who
11 comes in looking to register as a swap dealer.
12 MR. TOURANGEAU: Sure. So, there may be
13 the chance that someone that looks like NextEra
14 that has two businesses, one end user utility,
15 another more of a merchant energy, could be
16 designated as a swap dealer, but we're strictly a
17 non-financial company, so, the reg capital models
18 that have been used for financial companies will
19 not work for us because we're an asset-heavy
20 security lite type financial or non-financial
21 company, so, when you talk about Tier 1 or Tier 2
22 capital for someone like us, it just doesn't work,

1 or we don't have a lot of current assets that can
2 qualify under a reg cap model.
3 So, we're going to have to look at
4 different ways to define what's a well-capitalized
5 swap dealer for a non-financial, and one of the
6 ways that I think you're going to have to look at
7 very closely is looking at guarantees going up to
8 the holding company or the parent and making sure
9 that that would qualify as sufficient capital to
10 capitalize that non-financial swap dealer.
11 MR. REILLEY: Bob Reilley. I couldn't
12 agree more. This area, we definitely need some
13 flexibility. A large number of entities that
14 traditionally haven't been regulated in this way
15 may be in the future, and the approaches when used
16 in the past just won't fit a number of other
17 companies, including energy commodity merchants.
18 MR. MACCHIAROLI: I was just wondering
19 if (off mike) had any idea, on John's question,
20 how many people actually will register as dealers?
21 Is there any notion at all? We don't have,
22 frankly, any way to ascertain that.

1 (No response)

2 MR. MACCHIAROLI: No?

3 MR. RAMSAY: I guess one other question

4 is sort of at a crude level, obviously, regulators

5 have to try to figure what sort of capital levels

6 will be -- what to require in terms of minimum

7 capital requirements.

8 If you look at our side of the ledger at

9 the broker-dealer lite regime, which was

10 referenced earlier, just as a model or a reference

11 point, I think the requirements for those entities

12 are roughly $100 million in tentative net capital,

13 $20 million in capital requirements, and then some

14 other sort of bells and whistles. I guess,

15 arguably, one would start off with the assumption

16 with -- and, again, those are entities that, by

17 definition, are not holding a book of customer

18 business.

19 So, the question is: If you have

20 entities that are dealing directly with customers,

21 you need to take account of them. One might argue

22 you would start off from that sort of level, but,

1 presumably, want something more than that if
2 you're concerned about the fact that there's a
3 customer business involved. I guess the issue it
4 raises, the tension here from a regulatory
5 perspective is obviously the higher the capital
6 requirements, the less potentially competitive,
7 the more you close the door to potential
8 competition within the industry. So, if you're
9 talking about net capital levels of $20 million,
10 $50 million, or up as a minimum, what reaction do
11 people have to that? What issues do they think
12 that presents, if any? Does that unnecessarily
13 limit competition?
14 MR. COLLINS: It's Jim Collins. I guess
15 you would be referring to what type of activity
16 those entities do, right? If you deal with
17 large-scale broker-dealers, like many of us have,
18 that have a lot of customer activity besides
19 derivatives in it, we're dealing with numbers much
20 larger than even the broker-dealer requirements.
21 So, I guess you really have to look at what the
22 business is, and if it's only derivative risk,

1 then it's probably figure out where you're
2 comfortable on a pro-ration scale, but as you get
3 up in terms of dealing with large customers, I
4 think you have to make sure that you already have
5 firms that are subject to very high limits. If
6 you now set lower limits, then there could be some
7 competitive disadvantages.
8 MR. MATTONE: Ralph Mattone from Nomura.
9 I guess not really questions I have, but if you
10 would allow these entities to have multiple
11 registrations to be a swap dealer and a
12 securities-based swap dealer, it would determine
13 what's the minimum level that's going to be set
14 because the CFTC has their minimum, say roughly 8
15 percent, and then the SEC would have their
16 minimum, and by having two different minimums
17 would really determine how much they could put
18 into that type of entity.
19 MR. REILLEY: Bob Reilley again. We
20 really can't answer your question until we
21 understand what regulatory capital is. So, it's
22 possible to say how much is the right amount if we

1 don't even know what we're talking about. For
2 example, are we just talking about common equity?
3 And, if not, what would be added to it and taken
4 away from it?
5 MR. RAMSAY: Well, again, I mean, I
6 think if we are relying on the traditional scheme
7 in the securities area, you're talking about a
8 common equity, subordinated debt, subordinated
9 according to certain requirements and parameters,
10 but presumably, relying on the same scheme. So, a
11 fairly conservative definition of what would be
12 able to count towards capital. I think is where
13 we start off as an assumption.
14 MR. DRISCOLL: It's a little bit apples
15 and oranges, but the CFTC and NFA has been dealing
16 with retail FX dealers for several years, and the
17 capital requirements have gone steadily up over
18 the years until they're $20 million now; that's to
19 get in the door. And NFA, our view has been that
20 to truly be a dealer, you have additional risks
21 than you would just being an agency broker in the
22 securities and futures markets.

1 So, I agree that there's a big issue
2 about which of your assets count as good assets,
3 which is a lot of the firms around the table would
4 be the issue they have. But I would think you
5 need just an absolute dollar capital requirement
6 much higher than you would for an FCM or a
7 broker-dealer.
8 MR. RAMSAY: I guess another question,
9 which we talked a little bit about in the last
10 discussion was the extent to which, and this ties
11 in to capital requirements, whether firms
12 anticipate that they would be conducting business
13 through, where possible, existing firms through a
14 regulated broker-dealer/FCM or existing regulated
15 entity versus creating and capitalizing a new
16 entity.
17 Does anybody want to venture, either
18 speaking not necessarily for their own firms if
19 they have an affiliation, but any general thoughts
20 about where the market is likely to gravitate?
21 Does that make sense from a either prudential,
22 systemic standpoint, from the standpoint of

1 servicing clients? Otherwise any thoughts on
2 that?
3 Jim?
4 MR. COLLINS: Yes, Jim Collins. I would
5 think that particularly amongst the larger firms,
6 there's definitely going to be an incentive to
7 have your derivatives activity along with your
8 other activity, and you're a large broker-dealer.
9 I mean, there's capital, efficiencies, funding
10 efficiencies, operational efficiencies, margining
11 efficiencies. All that would be gained from doing
12 that. So, and while I can't speak for other
13 firms, you could definitely see where firms would
14 be looking to move their derivatives into their
15 large broker- dealers.
16 MR. MACCHIAROLI: For what reason is
17 that? Is it for credit or some other reason? You
18 said for margining, Jim.
19 MR. COLLINS: Well, yes, certainly,
20 margining benefits. They already have their
21 securities account in the broker-dealer, and now
22 you're bringing derivatives in. You'll get better

1 overall margining rather than margining them
2 separately, in two separate entities. Again,
3 capital benefits. You're capitalizing one entity
4 already where you may feel that you have more than
5 enough capital. And just doing things out of one
6 entity, one large, well-known entity to the street
7 has its benefits, just in funding particularly.
8 Large entities (inaudible) easier to get funding
9 on a day-to-day basis.
10 MR. GILLIS: Tom Gillis with Newedge. I
11 think as predominantly an FCM, one of the critical
12 issues with us would be portfolio margining and
13 the ability to offer that consistently to our
14 clients, and then we'd probably be more likely to
15 look at moving those swaps and securities-related
16 swaps into the greater broker-dealer.
17 MR. SILVA: Ralph Silva from Goldman
18 Sachs. Mike, to your question, I think one of the
19 added benefits to the firms is credit management
20 and the ability to offset credit exposures across
21 different businesses. In addition to being more
22 convenient to the customer from a margining

1 perspective, there are many ways that it gives the
2 firms better credit protection. I'm not sure that
3 Goldman Sachs is far enough along in understanding
4 the rules set to know whether we will concentrate
5 all of our business in a large broker-dealer, and
6 I think if we look at the way our businesses are
7 organized today, we expect we would have half a
8 dozen or more entities that would have to be
9 registered as swaps dealers, and that's something
10 that I think over time we would look to bring that
11 number down, but because of the interconnectedness
12 with other business, we'll have to see how the
13 rule set plays out.
14 MR. RAMSAY: I guess another aspect of
15 this that might be interesting to get people's
16 thoughts about is sort of the international
17 dimension, the capital requirements and other
18 requirements may impact where people choose to
19 sort of house business or locate business and kind
20 of the sort of international location in terms of
21 where much of the current OTC derivatives business
22 as we understand, much of it may be conducted

1 through banks, some of it may be conducted to
2 overseas.
3 The way we read Dodd-Frank, there's not
4 really the opportunity to create a carve out to
5 allow business to be conducted with U.S. clients
6 from overseas. So, how do people who are in this
7 business now or even if they're not, think that
8 things will play out in terms of a geographic mix
9 of business?
10 (No response)
11 MR. RAMSAY: Anyone want to venture an
12 opinion?
13 MR. MATTONE: I'll take a shot. Ralph
14 Mattone from Nomura. I think what we'll see is a
15 lot of that business, a lot of the foreign
16 entities are not going to want to have to register
17 securities-based swap dealer and deal with two
18 regulatory authorities. The FSA for argument's
19 sake, then they may have to deal with the SEC
20 rules and the CFTC rules. So, what you might see
21 is, again, setting up separate legal -- new
22 entities here in the U.S. just to deal with the

1 U.S. counterparties, but one negative aspect to
2 that is the capitalization of these new entities
3 won't be as large as the foreign affiliate that's
4 out there right now. So, there could be probably
5 less competition from over here, more of the
6 businesses going with those larger firms here in
7 the U.S.
8 MR. COLLINS: And it's Jim Collins
9 again. And, just to be clear, when we were
10 talking before about moving derivatives into
11 certain entities, yes, that clearly was commenting
12 on U.S. customer business, right? I just want to
13 be clear on that. I mean, there's a whole
14 separate analysis and lots of issues to deal with,
15 as you know, on the foreign side that we're trying
16 to work through.
17 MR. RAMSAY: Right. So, I guess getting
18 back to sort of how one measures capital, and,
19 again, sort of different kinds of approaches, are
20 there alternatives to a traditional haircut
21 approach for at least certain kinds of business,
22 and I don't know if this makes more sense in terms

1 of the CFTC side of the ledger than sort of
2 financial products, where one can imagine or
3 suggest a more sophisticated kind of haircut
4 approach or an approach that recognizes hedges,
5 maybe more granular level than the current haircut
6 approach does that would be viable from a business
7 standpoint. Is there a point in sort of trying to
8 go down that road?
9 MR. SILVA: Ralph Silva from Goldman
10 Sachs. As a few of the other panel members have
11 mentioned, many of these entities are already
12 subject to multiple capital regimes from a parent
13 company level, from an individual broker-dealer or
14 foreign broker-dealer level, and, so, I think it
15 is our view that building in the context of an
16 existing regulatory regime or modeling after an
17 existing regulatory regime would be preferable to
18 creating yet another new one, something that could
19 rely on models that are used for other regulatory
20 purposes, for instance. And, again, wouldn't
21 require new types of models or new standardized
22 models that are different from those that are used

1 in both risk management and current regulatory
2 capital reporting.
3 MR. RAMSAY: I guess another question
4 that we're starting to grapple with or have to
5 grapple with after the legislation is the
6 treatment of major swap participants, figuring
7 out, number one, who they are, and then how to
8 treat those for capital and other purposes. If
9 people have any thoughts on how entities that are
10 defined as major swap participants, let's pretend
11 that we know who they are, how to identify them,
12 ought to be treated similarly to swap dealers for
13 purposes of capital requirements or should there
14 be some distinction there or maybe subject to
15 another test?
16 So, does anybody want to take a stab at
17 that?
18 (No response)
19 MR. RAMSAY: Anyone in the audience?
20 (Laughter)
21 MR. DRISCOLL: Dan Driscoll from NFA.
22 And not that I know exactly who all the major swap

1 participants will be, but, presumptively, there
2 will be hedge funds, and perhaps companies that
3 deal with the underlying instruments that are the
4 subjects of the derivatives. So, I think they'll
5 be probably even less financial institutions,
6 broker-dealers, and FCMs that fall into that
7 category. So, all of the troubling issues about
8 how to fit those firms into that model I think
9 will exist with major swap participants, as well,
10 probably even more so.
11 MR. RAMSAY: I guess following-up or
12 borrowing on an issue that arose in the last panel
13 in terms of margin and whether one can sort of
14 rely on capital charges as an alternative to the
15 posting of margin for firms that are either in the
16 business or maybe getting into the business to
17 people, is that a viable alternative way to --
18 sort of business model? Do people think that
19 firms will be able to take on, would able to
20 absorb that additional capital requirement or not?
21 Or in some circumstances but not others?
22 MR. GILLIS: Tom Gillis with Newedge. I

1 think one of the challenges that we will see in
2 this space is the tenor of some of these
3 transactions. We may see an initial burst, if you
4 will, of firms that will be able to handle the
5 charges, but, over time, as these portfolios grow
6 and extend out, we may see some of the medium size
7 to smaller firms experience some capital
8 difficultly if they're absorbing that margin, if
9 you will, through their capital charge.
10 MR. COLLINS: It's Jim Collins. I guess
11 another point to consider is that right now if you
12 look at, for example, minimum capital requirements
13 that we have in place for FCMs now, for example,
14 where you're basically taking a percentage of your
15 gross exposures, so, as you move more business
16 into these entities, certainly, the minimum
17 capital requirements in and of themselves are
18 going to increase. If you're then also taking
19 capital charges for unsecured exposures on T or T
20 plus one, that could get to be very onerous,
21 particularly for smaller entities or entities that
22 are growing. And I think that needs to be taken

1 into account that it's kind of worked, the 8
2 percent of the customer and the house margin for
3 the exchange trade of business, but as you move
4 into OTC derivatives and look to take charges in
5 other ways, as well, it could become prohibitive
6 to some firms and ultimately hurt competition.
7 MR. RAMSAY: So, would you say then with
8 most of the end users out of the room that you
9 think we should require the posting of margin and
10 avoid the capital charges?
11 Please.
12 MR. MACCHIAROLI: Jim, do you think that
13 the rules in the ANC context now, the credit rules
14 we set up are adequate for this purpose, where you
15 look at the credit exposure of a particular
16 customer and you compute the current and future
17 exposure and determine how much percentages should
18 take in the capital charge are adequate or should
19 be changed?
20 MR. COLLINS: I think that a risk-based
21 approach where you're looking at the counterparty
22 and the probability of default and those kinds of

1 factors is a little bit more accurate way to go
2 rather than just taking credit risk charges on any
3 unsecured exposure that you have. I realize there
4 have been some issues with it, and maybe you need
5 to work it through, but I just think a risk-based
6 approach to the credit is a better alternative.
7 Does that address what you --
8 MR. MACCHIAROLI: Is it adequate? I
9 mean, are the numbers right or should --
10 MR. COLLINS: I mean, we believe them to
11 be accurate, yes. And, again, larger firms I
12 think that have more resources, right? I mean, we
13 have very extensive risk management on both the
14 market risk and credit risk side in reviewing
15 this, and making credit decisions on a daily
16 basis.
17 MR. MACCHIAROLI: (Off mike).
18 MR. DRISCOLL: Go ahead.
19 MR. SILVA: Yes, I agree with that.
20 MR. DRISCOLL: I'm sorry. On major swap
21 participants, and maybe I misread the statute, but
22 in determining whether a firm is a major swap

1 participant, the end user hedges are excluded from
2 that, and the whole presumption of major swap
3 participants is that they're big enough to have a
4 systemic importance.
5 So, at least in the way I envision it,
6 there shouldn't be any really small operations to
7 fit into that category, and if most of the OTC
8 products are going to end up being cleared and on
9 some sort of trading facility, it would seem to me
10 that one of the major concerns for that
11 registration category would be liquidity because,
12 presumably, they are going to have to post margin
13 for just about everything that they do. So, they
14 may have a balance sheet that looks different than
15 a broker-dealer or an FCM, but they're going to
16 need a lot of liquidity and they're going to need
17 a lot of assets. And, so, it would seem to me
18 that somehow we need to make sure that they have
19 high levels of liquidity either through their own
20 assets or through secured credit facilities of
21 some sort.
22 MR. RAMSAY: And I suppose if they're

1 transacting mostly in cleared products then the
2 clearinghouse is going to do some diligence and
3 obviously impose requirements on its own for its
4 own prudential purposes.
5 To the extent that it engages in other
6 kinds of activities, I guess what I was sort of
7 suggesting is from a regulatory perspective, we
8 don't have much history in trying to regulate from
9 a capital perspective, don't have any really.
10 These kinds of entities which may present some
11 sort of a systemic risk at some level, but are not
12 engaged in the business in the way that we think
13 of dealers being engaged in. So, certainly a
14 difficult threshold issue for us is how to think
15 of those, how to treat them.
16 Now, under the statute, firms that are
17 really big or have really significant exposures to
18 different counterparties could be candidates for
19 designation as a systemically significant
20 financial institution. In those circumstances,
21 there's a different regime or at least prudential
22 limits that would apply to them. So, I guess

1 there's a range of different kinds of potential
2 options.
3 One is to the extent that you identify
4 major swap participants, you apply the same kinds
5 of general capital requirements as you would
6 broker-dealers or swap dealers. Another is that
7 you, not knowing what else to do, impose fairly
8 minimal requirements, assuming that any other
9 requirements that may need to apply to them will
10 be handled in other ways, whether through
11 clearinghouse margin or other things, and, so, I
12 guess that's one question we'll have to try to
13 address, and we'll be looking for public comment.
14 MR. RADHAKRISHNAN: I wanted to raise an
15 issue which is specific to the CFTC, and don't
16 expect your sympathy, but this is the issue that
17 we're facing. We will have entities that will
18 have to register as swap dealers. What I would
19 call entities that we've never regulated before.
20 Well, first of all, the concept of a dealer until
21 Dodd-Frank didn't exist in the CEA, right? So,
22 but now it does. SEC has got experience dealing

1 with dealers.
2 And the other issue these entities will
3 be regulated for activity that they were not
4 regulated before, right? In other words, if
5 you're (inaudible) you cannot be an FCM until you
6 register, right, and you cannot be an FCM, you
7 can't act as an FCM, you can't legally act as an
8 FCM until you register and until you have minimal
9 capital requirements. Now we're going to have to
10 impose capital requirements on entities that were
11 dealing in swaps. On day one, they didn't have to
12 anything. On day two, they've got to register,
13 and then they're going to be subject to capital
14 requirements. So, that's one issue.
15 The second issue is you've got these
16 entities called push-out entities, right, which
17 are financial-type funds, right? Banks got to
18 push them out, and they will probably have to
19 register with the SEC and us or some may just be
20 with them, some may be just with us. But because
21 we believe they will (inaudible) they'll be
22 financial-type entities. We sort of think we have

1 an idea as to how to impose capital requirements.
2 But the bigger issue is with -- sorry,
3 Bob. Let's say Bob's company has to register as a
4 swap dealer. I'm not saying you do, but let's say
5 you do. Let's say you do. How do I impose a
6 capital requirement on Shell Trading? Is it Shell
7 Energy? Yes. Because if I pick the current CFTC
8 haircuts based approach he'll squeal because he'll
9 say look, a lot of my assets will not meet your
10 current asset test. And potentially it may not be
11 fair, right?
12 So, what is the approach? Is it a
13 network approach or is there some other kind of
14 approach? And, also, if we say well, use a model.
15 Bob may say well, it's not going to help me. I
16 thought I heard you say that. The models are not
17 going to help you. So, give me an idea, and I
18 know that it's strange that I'm asking a potential
19 (inaudible) how to regulate him, but.
20 MR. REILLEY: I'll answer.
21 MR. RADHAKRISHNAN: And I'm not saying
22 we'll agree, too.

1 MR. REILLEY: I'll answer your question
2 hypothetically.
3 MR. RADHAKRISHNAN: Absolutely,
4 absolutely.
5 (Laughter)
6 MR. REILLEY: Just in case the
7 Commission makes a terrible mistake.
8 MR. RADHAKRISHNAN: Absolutely, and as
9 you know, the definitions proposed rule-making,
10 the Commission voted on it, CFTC voted on it. I
11 think SEC voted on it, too. But because of how
12 long it takes for stuff to go to the Federal
13 Register, it's not out yet.
14 MR. REILLEY: I think Dan referred to
15 "apples and oranges" situations a few minutes ago,
16 and it's worse than that. It's like trying to put
17 shoes on a fish, all right? (Laughter) When you
18 take a look at, for example --
19 MR. RADHAKRISHNAN: Can I use that?
20 It's pretty nice. (Laughter)
21 MR. REILLEY: For example, when you take
22 the FCM approach and attempt to apply that to a

1 trading company like ours, if there's 30 different
2 line items in that formula, 20 of those line items
3 do not appear on our balance sheet. It's just a
4 starter. It doesn't make sense.
5 I guess beyond that, there needs to be
6 an approach that takes into account the nature of
7 an applicant's business, and I suspect it's going
8 to be a range of entities. It's not just going to
9 be energy- producers and merchants. So, things
10 like accounts receivable, accounts payable, just
11 the existence of large, physical assets, all of
12 those things need to be taken into account. And,
13 so, I can't sit here and tell you how to do it.
14 What I do know it's going to be a big
15 task, and it's very important because, otherwise,
16 you're likely to come out with really absurd
17 results where there will be companies that I think
18 anybody would agree are credit-worthy, but,
19 nonetheless, won't meet the capital requirements.
20 MR. DRISCOLL: The CFTC, back in the
21 late 70s, when the current capital requirement
22 essentially was put together, received comments

1 from a number of large commodity-producers and
2 merchandisers that they would have trouble meeting
3 the -- because the CFTC was basically normalizing
4 their rules with SEC rules. And, so, there was a
5 process that went on where the CFTC did include
6 certain assets that are different than the SEC's
7 rules like trade receivables, like inventory of
8 commodities with certain haircuts and things like
9 that.
10 Now, as a practical matter, what
11 happened in practice is all those large producers
12 and merchandisers decided for their own business
13 purposes to set up a financial affiliate to become
14 registered as an FCM. So, I'm not sure that we've
15 seen any actual assets in those line items in the
16 last 20 or 30 years, but it does show that -- and
17 basically what you need to do is let Ananda know
18 what those assets you have are that don't fit to
19 see what the CFTC might be willing to say. At
20 least we could give you a certain amount of credit
21 for that type of asset. It basically takes a
22 dialogue back and forth.

1 MR. RADHAKRISHNAN: Yes. And, Dan, that
2 is the point. I don't think it is certainly the
3 intention of staff to recommend to the commission
4 that people change their business models. In
5 other words, oh, you should form a separate sub,
6 and I think that's probably not right, and we
7 should allow entities to conduct business in
8 whatever structure they want to have it in.
9 The other issue is these entities will
10 be registered with an existing book. So, what do
11 we do with that, because the big issue is all the
12 provisions of Dodd-Frank apply to activities going
13 forward after that particular magic date in July
14 next year or do they have retrospective effect?
15 So, I think I've heard a lot of industry
16 participants say we don't believe the intention of
17 the act was for it to have retrospective effect;
18 it's to have effect from a particular date going
19 forward. So, but then it presents another extra
20 issue, which is what do we count? What counts?
21 What do you need to have capital against and how
22 do you separate a book before July 15, 2011, and

1 after that?
2 Yes, sir?
3 MR. TOURANGEAU: On your last point
4 there, I think we would agree that it would only
5 be prospective and not retrospective.
6 Going back to your other point though
7 about not forcing people to develop a new entity,
8 I think a current reading could suggest that's
9 exactly what some people would have to do in order
10 to segregate their business because even within
11 one entity, they may feel that part of that
12 business should be exempt end user and some of it
13 may qualify as a swap dealer. So, if that's the
14 way that they have to go, and I made the point
15 before, I think our feeling is if that were to
16 happen and we need to create a new entity, that we
17 would still want for the regulatory capital
18 requirements to be able to look to a parental
19 guarantee back to the holding company or something
20 like that to satisfy those regulatory capital
21 requirements.
22 MS. DIAZ: And let me ask a question

1 about that parent guarantee. Is that on the
2 assumption that there are more liquid assets at
3 the parent that could be called upon?
4 MR. TOURANGEAU: It's a combination of
5 credit line, liquid assets, and also hard assets.
6 So, but again, a lot of the energy companies,
7 whether it be an EMP company, whether a marketing
8 arm, or a utility with a merchant-generator arm,
9 are going to be more asset-heavy and cash and
10 current asset lite.
11 MR. DODD: (Off mike).
12 MR. RADHAKRISHNAN: Just speak -- yes.
13 MR. DODD: This is Randall Dodd. I
14 think doesn't Title VI indicate that the parent
15 should be a source of strength for the subsidiary
16 as part of that systemic stability requirement?
17 So, it would be consistent with that other part of
18 Dodd-Frank.
19 I was also going to suggest at the
20 expense of appearing to be brainstorming, that I
21 could imagine how you could apply the current
22 capital requirements to some of these

1 non-financial firms or traditionally non-financial
2 firms and that a lot of these assets that are
3 normally fit into the definition of financial
4 assets could be looked at as a hold and maturity
5 asset from what we normally treat it as the
6 banking book of a financial firm, and then you
7 could then look at their trading book as their
8 value at risk of their total portfolio of the
9 market-to-market value of their ongoing market
10 activities as a energy producer or user, and then
11 their trading activities around that. So, if you
12 were fully hedged, you'd have very little value at
13 risk, no problem. If you're acting as a dealer,
14 then to the degree your book wasn't matched, you'd
15 have some value at risk, take a capital charge on
16 that. Your trading book, your kind of irregular,
17 if you will, assets, right, would just be that.
18 You would take some kind of a capital charge as
19 though it was a normal asset at risk, but not
20 market-to-market daily. And, so, that way you
21 could get at some of the issues, and that if a
22 firm is just fully hedging, then very little

1 capital impact. If it's a trader and it's got
2 some natural mismatch as a result of the volume of
3 that activity, they get a proportionate capital
4 hit on that, right?
5 MR. TOURANGEAU: Yes.
6 MR. DODD: And then their adequacy would
7 be enhanced. Then you would count their other
8 illiquid assets as capital though, right? I mean,
9 then you would bring them in as something you get
10 credit for. So, just brainstorming, that might be
11 one way to adapt it.
12 MR. TOURANGEAU: Mike Tourangeau. I
13 think we, in concept, agree with that approach in
14 that the capital charge could be a percentage of
15 the risk exposure, maybe one way to look at it,
16 and then the assets that you apply to that are
17 exactly what you're referring to, which are the
18 hard assets, the assets which basically sustain
19 your cash flow.
20 MR. RAMSAY: I mean, I guess, one of the
21 things that it strikes me that all of the
22 discussion today has sort of brought home is,

1 again, how diverse the derivatives markets are in
2 terms of the players and the range of end users,
3 as well as participants, and I guess we've been
4 operating, the regulator's been operating from an
5 assumption on things like capital in particular.
6 There's sort of one model that sort of applies
7 across the board, is there any potential or
8 argument that different sorts of firms, there
9 ought to be a different structure depending on who
10 you are? That is if a firm that largely or
11 exclusively confines its business to dealing in
12 cleared products, but that's a different sort of
13 structure that might be treated differently than
14 firms that are heavily involved in un-cleared
15 products? Or is that too difficult a cut, too
16 difficult to make distinctions along those kinds
17 of line?
18 (No response)
19 MR. RAMSAY: Too difficult, it sounds
20 like. Jim?
21 MR. COLLINS: John, are you talking
22 about, so, for example, having it could be I can

1 see more than two different regimes? You can have
2 a very large regime for the large dealers, and
3 then you're talking about the smaller firms or
4 smaller activity and one that just has cleared
5 activity and then another regime for firms that
6 have un-cleared, and then what do you do when they
7 have cleared and un-cleared?
8 MR. RAMSAY: Well, yes, it would be
9 complicated, definitely. When you talk about
10 firms like sort of at the (inaudible) on the
11 alternative net capital firms that are conducting
12 sort of a full range of business, so, you have
13 sky-high requirements in terms of tentative net
14 capital and sort of everything else. So, that
15 sort of one. And then potentially you've got
16 other firms that are not doing a traditional
17 securities or a futures business, and may be
18 looking only to do swaps, security-based swaps
19 business.
20 Should we look at those firms any
21 differently in terms of what minimum capital
22 requirements might need to be -- can we reasonably

1 make distinctions in terms of the mix of business
2 that firms are proposing to do? I'm not
3 suggesting that we would or that we'd try to go
4 very far down that road. I'm just raising the
5 question.
6 MR. COLLINS: I think it's hard to
7 disagree with that type of approach, right? I
8 mean, it certainly would make sense. I mean, just
9 how you implement that I think requires a lot more
10 thought. I can't really say how we would do it
11 right now. It certainly seems to make sense.
12 MR. RAMSAY: Professor?
13 MR. VISWANATHAN: Yes, this is Vish
14 Viswanathan. I would agree that liquid products,
15 I think cleared products make some sense. There's
16 kind of less systemic risk in some sense because
17 it's clearing, there's margining. Perhaps, should
18 be treated differently. I don't know exactly how,
19 but there is an argument, I think, to be made that
20 we should make a distinction, be it cleared
21 products and un-cleared products.
22 MR. RAMSAY: Well, certainly, you have a

1 second or third or different sets of eyes looking
2 at counterparties when they're dealing solely in
3 cleared products, and maybe not relying so much
4 just on the regulatory review. In any event, I'm
5 confirmed with Ananda that we are not duty-bound
6 to make it to 5:00. (Laughter) Considering we're
7 already going fairly late on a Friday afternoon, I
8 mean, I won't take a vote of the panel either at
9 this point. (Laugher)
10 What I would suggest maybe is I throw it
11 open to the group if there are points that people
12 haven't made to this point that they would like to
13 make about -- since you've got captive regulators
14 in front of you, as to how you think we ought to
15 go about the business either creating capital
16 requirements or anything else that's on the table.
17 Any thoughts you'd like to throw out, we'll try to
18 take them and try to remember them.
19 MR. MACCHIAROLI: Could I ask one
20 question? To use the VaR in the broker-dealer,
21 you need a tentative net capital $5 billion, which
22 is pretty much a hard limit, and there are some

1 folks who would like to put the stuff in the
2 broker-dealer who can't because of that $5 billion
3 requirement. I'd like to hear why that is not a
4 rational approach. Why your approach might be
5 better? (Laughter)
6 MR. MATTONE: I think I've asked that
7 question, too, every time I see it. (Laughter)
8 And I keep getting the same answer. (Laughter)
9 MR. MACCHIAROLI: But now you have --
10 MR. MATTONE: Okay, obviously, being
11 that my firm is a VaR firm, we do use VaR models
12 that come under scrutiny, like I said, by the FSA
13 and the JFSA. So, they're all looked at, they're
14 constantly being retooled and reworked and so
15 forth by being reviewed, and, so, we feel as
16 though eventually we'll get to that $5 billion
17 threshold maybe over time, so, we're looking at
18 maybe in the beginning it'd be like a phase-in
19 period for our firm and so forth like that, that
20 if we can use the model approach, which we've seen
21 that it works with the larger firms and so forth
22 like that, that, over time, we would reach that

1 level.

2 MR. RAMSAY: Would you care to

3 categorize the quality of the review and model

4 review you get from the FSA as compared to, say,

5 the fed or other regulators?

6 MR. MATTONE: Well, I personally can't

7 comment on that because I'm not that close on that

8 side, but I know from what I've heard there is a

9 lot of going back and forth, and I think the SEC

10 deals with those regulators overseas and so forth,

11 but I personally can't answer that.

12 MR. COLLINS: And I think that you would

13 have to make the point, I mean, where the large

14 U.S. broker-dealers that are using the models and

15 have the $5 billion requirement, we have also

16 Federal Reserve as a potential regulator that's

17 looking at our models, as well. So, I think you

18 have to figure out how to make it a level playing

19 field. I think maybe a phase-in period is

20 appropriate, but, eventually, everyone needs to be

21 on the same footing, whether they're a U.S.

22 prudential regulator or a foreign prudential

1 regulator.
2 MR. RAMSAY: Well, I think it's fair to
3 say that at least within the U.S., we are
4 certainly looking to leverage resources in terms
5 of reviews on capital models and various other
6 things as much as we can, and, also, obviously
7 coordinate and be consistent in terms of how we
8 look at these thing across the board. Any other
9 parting thoughts on how we ought to regulate in
10 this area going forward?
11 MR. MACCHIAROLI: I would like to ask
12 one question, and, again, it would go to those
13 folks who don't like the net liquid assets test.
14 How would an examiner examine for capital in a
15 firm where the assets could not clearly be valued
16 by the examiner? Or using the holding company,
17 the examination staff be required to examine the
18 holding company that's guaranteeing this entity
19 where it's being used as capital?
20 MR. TOURANGEAU: I mean, the assets
21 typically are on the balance sheet, and, so,
22 they're there and they're valued. Now, it depends

1 on I think in some models you look at, you may
2 look at market value versus the purchase value,
3 the original value on the balance sheet, but,
4 typically, a lot of them will be on the balance
5 sheet. Some may be off the balance sheet, at
6 which point there may need to a discussion as to
7 how to value those, but the majority, I think,
8 would be on the balance sheet.
9 MR. MACCHIAROLI: How would the examiner
10 know what the value was in determining what the
11 net worth of this enterprise was? And you want to
12 use a guarantee of the holding company's capital
13 in the regulated entity. Would the examiner then
14 have to look at the regulated at the holding
15 company?
16 MR. TOURANGEAU: Well, I mean, it could
17 be different entities' guarantees from different
18 entities above that. So, it may the holding
19 company, it may be another affiliate who has a
20 series of assets or something like that. It
21 depends on the structure of the corporation. But
22 I don't know enough to know what the examiners

1 would go. I mean, they would obviously have to
2 have a window into those assets to be able to get
3 comfortable with the valuation on that, and
4 determine that there's a sufficient enough amount
5 of capital to cover the exposure under the
6 guarantee.
7 MR. REILLEY: Just a couple of last
8 thoughts here. I mean, I think maybe the main
9 thing that I'd like for the regulators to take
10 away from this session today is the idea that a
11 one size fits all solution will work, probably
12 just doesn't work in terms of anything that we've
13 been discussing. And that includes trying to use
14 exchange-type financial metrics and apply them to
15 non-financial companies, non-financial trading,
16 trading that's mainly in physical commodities.
17 Now, the concepts just don't translate well.
18 And I guess my other comment goes to the
19 retroactive application, and there was a question
20 about well, gee, what do we do with existing
21 portfolios for purposes of capital? I'd say that
22 I think if we take the existing portfolios, we

1 certainly should not try to apply margining
2 requirements to them. I mean, that would that
3 undermine sanctity of contracts. Those deals were
4 done with a particular set of standards in mind,
5 and we can't change in midstream. The same with
6 clearing requirements on existing historic
7 transactions or pre-enactment, pre-effective date
8 transactions.
9 And I'd say it should even go to things
10 like the designation of swap dealer. Under the
11 proposed rules, it has to do with how you're
12 conducting yourself at a particular point in time.
13 Well, if July 16 comes and the entity is let's
14 just say no longer entering into bilateral swaps,
15 it may still have a very large portfolio bilateral
16 swaps cleared and un-cleared done in the past.
17 That should not cause it to somehow or another
18 trip the definition of swap dealer.
19 MR. RAMSAY: There are a lot of hairy
20 questions that I guess will just have to sort of
21 be played out, but in terms of the sort of
22 transition, how you sort of do the transition, if

1 you assume that there are some class of energies
2 out there that are going to want to register that
3 will have an existing book that will be subject to
4 you, I guess the choices are you either require
5 people to set up a new entity and create a book
6 that will be subject to the new requirements or
7 you have an existing entity that somehow the books
8 are split in two between those that sort of are
9 subject to the old rules versus the new. I'm not
10 really sure how all of that would work. But, I
11 mean, does anybody have a thought on whether is
12 this is a real problem, a real practical issue, or
13 is it not a problem, not an issue because whatever
14 entities register will be entities that are
15 registering based on new business and not business
16 that they are already conducting?
17 MR. SILVA: Ralph Silva. I think that
18 building some sort of flexibility into the rule
19 set and into a transition period is very important
20 because I think it isn't clear to me from a policy
21 perspective that you want to encourage the
22 creation of many, many new entities to draw a

1 bright line, and many of these longstanding
2 customer dealer relationships can't just be
3 terminated all of a sudden and start anew the next
4 day. And, so, I think if there's too bright a
5 line one way or the other, there's likely to be
6 some sort of market disruption and unintended
7 consequences. So, I think building some sort of
8 flexibility and extended transition period will be
9 very important if it's not your desire to disrupt
10 the market.
11 MR. COLLINS: Yes, it's Jim Collins. I
12 would agree with Ralph. I mean, I think another
13 aspect I'm thinking of is when you get to
14 derivative push out and you're moving derivatives
15 potentially from a bank entity out into a
16 broker-dealer entity. I mean, I'm not sure how
17 we're going to handle that, but certainly, as you
18 said, you can't just go and recreate everything
19 that you've done. And there's an issue of whether
20 you're just going to be moving prospectively or
21 are you going to be moving legacy positions, as
22 well? And, quite often, it might make sense to

1 move the entire book to keep the risk together,
2 but then if you're going to be subject to the --
3 we're going to have to re-margin or start from
4 scratch, that certainly is an issue when dealing
5 with your counterparties.
6 MR. RAMSAY: Anybody else? Are we ready
7 for a vote on whether to -- (Laughter) Yes?
8 MR. GILLIS: It's Tom Gillis with
9 Newedge. In changing it up a little bit and maybe
10 going back more to the earlier session on margin,
11 one of the things that we think about often is
12 under the CEA Sections 130 and 156, we're not
13 permitted to extend credit. So, if we are not
14 collecting margin on non-cleared derivatives, will
15 that be considered an extension of credit? We
16 talked earlier about what that would mean in terms
17 of our capital implications, but that's just
18 something that we've talked a little bit about.
19 If we interpret that literally, we could be seen
20 as extending some credit. I don't know if there
21 are any other thoughts on that.
22 (Pause)

1 MR. RAMSAY: All right. Going once,
2 going twice. Yes?
3 MR. TOURANGEAU: I guess I'd just like
4 to follow-up with what Ralph said on timing. I
5 think not just specific to capital and margin,
6 but, in general, there are a lot of
7 interdependencies between these NOPRS and us, so,
8 interdependencies between the CFTC and the SEC and
9 other prudent regulators, and, so, I think it's
10 important. I know the act does mention timelines,
11 but I also believe that the regulators have the
12 discretion to push those out if they deem it
13 necessary, and, so, I think we would just stress
14 that the time we take and to fully analyze a cost
15 and benefits associated with all of these NOPRS,
16 these regulations before they go into effect and
17 then, again, give the proper transition times to
18 allow people to react so that the market
19 disruptions aren't severe.
20 MR. RAMSAY: No, and we'll take the
21 liberty of speaking for CFTC, as well, as I think
22 we're very sensitive to the fact that the

1 requirements in terms of when we have to adopt
2 rules don't preclude us from providing appropriate
3 timeframes for people to adjust in reacting to
4 them and dealing with them, and that's certainly
5 something that we're very focused on as we go
6 forward in crafting these requirements.
7 So, with that, I guess I'll take the
8 prerogative to thank you for lasting as long as
9 you have on a difficult set of topics late on a
10 Friday afternoon, and thank you for giving your
11 time to be here. Thanks.
12 (Whereupon, at 4:27 p.m., the
13 PROCEEDINGS were adjourned.)
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1 CERTIFICATE OF NOTARY PUBLIC
2 DISTRICT OF COLUMBIA
3 I, Christine Allen, notary public in and
4 for the District of Columbia, do hereby certify
5 that the forgoing PROCEEDING was duly recorded and
6 thereafter reduced to print under my direction;
7 that the witnesses were sworn to tell the truth
8 under penalty of perjury; that said transcript is a
9 true record of the testimony given by witnesses;
10 that I am neither counsel for, related to, nor
11 employed by any of the parties to the action in
12 which this proceeding was called; and, furthermore,
13 that I am not a relative or employee of any
14 attorney or counsel employed by the parties hereto,
15 nor financially or otherwise interested in the
16 outcome of this action.
17
18
19 -----------------------------------
20 Notary Public, in and for the District of Columbia
21 My Commission Expires: January 14, 2013
22