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P R O C E E D I N G S

(9:35 a.m.)

MR. RADHAKRISHNAN: Good morning. I think we'll start.

MS. O'BRIEN: All right.

MR. RADHAKRISHNAN: Morning. My name is Ananda Radhakrishnan. I'm with the Division of Clearing and Intermediary Oversight, CFTC, and welcome to the Staff Roundtable on the Protection of Cleared Swaps Customer Collateral. I appreciate everybody's participation.

There will be three panels. The first one is "Implementation"; the second is "The Option Approach"; the third is "The Advantages and Disadvantages of The Complete Legal Segregation Model in comparison to Legal Segregation with Recourse, the Futures Model, and the Optional Approach".

CFTC staff participating: Martin White from the Office of General Council and Bob Wasserman from DCIO; Laura Astrada from DCIO; and David Reiffen from the Office of Chief Economist.

So, I'm going to hand it over to Bob, who will be conducting most of today's proceedings. Thanks.

MR. WASSERMAN: Thank you. I'm going to start with some housekeeping details. This meeting is being recorded, and there's a court reporter. Microphones are push-to-talk, so please press the button on the microphone and speak into it. When the light appears red, your microphone is on. And then when you're finished talking, please press the button again to turn it off. Please keep your Blackberries and cell phones away from the table as they can cause interference.

Bathrooms are outside, down the hall, far back. And we're going to be taking a break after this panel, a break at noon for lunch, and then in the middle of the third panel at around 3:15.

So, I think the best way to start is to just have everyone introduce themselves, and then off we go.

MR. WINTER: Steven Winter, State Street, head of the futures and swap clearing business.

MR. SZYCHER: Mark Szycher, General Motors Pension Plan, head of risk management.

MR. THUM: Bill Thum, Vanguard, Legal Department.

MS. BREGASI: Nevis Bregasi, MFS Investment Management, Legal Department.

MS. AYOTTE-BRENNAN: Christine Ayotte-Brennan, Fidelity Investments, Fixed-Income Legal.

MR. COX: Rupert Cox, Brevan Howard, risk management.

MR. MACFARLANE: John MacFarlane, Tudor Investment Corporation, vice chairman, general management.

MS. MEDERO: Joanne Medero, BlackRock.

MR. MAGUIRE: Daniel Maguire, LCH Group, risk management.

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

MS. TAYLOR: Kim Taylor, CME Clearing.

MR. FRANKEL: Oliver Frankel, Goldman

Sachs.

MR. DIPLAS: Athanassios Diplas, Deutsche Bank, global markets.

MR. NICHOLAS: John Nicholas, Newedge USA, Legal Department.

MR. WASSERMAN: And then on the phone?

MR. COCCO: Alessandro Cocco, JPMorgan, Legal Department.

MS. O'BRIEN: Edith O'Brien, MF Global, Treasury Department.

MR. WASSERMAN: Let's get started. So, this panel is on implementation issues, and I think the biggest question is what are the steps that would need to be taken -- and we're going to first start with the proposed complete legal segregation model, and then we will move on to how those steps would be changed if we were to adopt either the legal segregation with recourse model or the futures model or one of the optional models.

So, starting with the complete legal segregation model, if I could have some folks from the buy-side talking about the steps they would need to take, and then I'll move onto the firms and the clearing organizations.

MR. THUM: Sure, it's Bill Thum at Vanguard. We are very active in the bilateral OTC derivatives market and have trading relationships across the street. We have collateral arrangements on a fully collateralized basis, and we are talking to several FCMs at present to valuate them serving as our FCMs for cleared derivatives. We have been engaged with them in terms of understanding their infrastructure, their strengths in terms of assessing the credit risks presented by clients, and as well having them evaluate our portfolios to understand what is clearable by which clearinghouse and assessing the margin levels that each clearinghouse would present.

We have very active relationships already where the dealers and the FCMs are very familiar with our funds. We have already exchanged all the money laundering information.

That's all accomplished. So, at this point we are moving through developing the relationship.

From there we have to engage in the dialogue on the documentation, which involves upgrading our futures agreement to address cleared derivatives, signing up the addendum to the futures agreement, and then entering into the execution agreements with the different executing brokers.

So, we see that playing out over possibly a year to two years, engaging with our investors and clients to explain to them the implications of the new cleared swaps world; having upgrades to disclosure in the fund documentation; and having the investment management agreements upgraded to address clear derivatives. And obviously the issue presented by the protection for margin for cleared derivatives raises a number of issues, and depending on how the Commission comes out on this and we support the full legal segregation model or the LSOC model as it's otherwise known, we will have to explain to the clients how their margin will be treated if it's going to be treated differently in the cleared world than it is in the uncleared world.

In the uncleared world, as I said, we have the CSAs; we have bilateral collateral arrangements; and we have custodians set up where the margin that we post and the margin that we receive are held by custodians. It was very useful for us in the Lehman bankruptcy to have the margin there, so we have invested heavily in that infrastructure to protect the margin, and we would have to engage in significant dialogue with clients if we had to explain any changes or weakening of the protection for margin.

MS. AYOTTE-BRENNAN: It's Christine Ayotte- Brennan from Fidelity. We are doing the same process as Vanguard is going through now talking to FCMs, talking to clearinghouses, and getting on board.

I think a few of the other things that we have to do to be ready to implement any collateral system that is chosen is that our back office has to work with both the FCMs and the DCOs to make sure that they can reconcile the margins calls that will be made. So, all of that back office work still needs to be done regardless of which model is chosen. And as Bill mentioned, we also have to go out to the clients and talk to them about how collateral is going to be managed in the new derivatives world. And, again, regardless of which scheme is chosen, we will have to do that.

So, in terms of being ready to implement one of these things, when we think about what is best for the clients, we fully support the complete legal segregation as well. And when we look at that, we think it's, one, the best protections for the client and, two, it will not take any longer to implement than the other choices, because we will have to do the back office work and go to the clients regardless of which is chosen.

MR. SZYCHER: Mark Szycher from GM Pension. I'd echo the sentiments and some of the work that both William and Christine's organizations are doing regarding complete legal segregation.

I would also add two other elements that I think would be very important. I mean our implementation process, the first of which is to make a thorough assessment of investment risk. You know, as the proposed rule has detailed, we recognized that though the fellow customer risk perhaps has either been eliminated or at least greatly mitigated by complete legal segregation, we still maintain a degree of investment risk as our collateral has been transformed or otherwise invested by the FCM.

Furthermore, and perhaps even more importantly, the ultimate effectiveness of complete legal seg in a bankruptcy or double-default situation would really rely on the completeness and accuracy of the records that are being held by the FCM to figure out what we're actually holding and, therefore, what we are supposed to receive back. I think our significant practical concern with the proposal, or at least the way things are done today, is that in essence we would be reliant upon what is going to be a defunct or bankrupt entity or certainly in-serious-trouble entity to, in fact, maintain those records.

I'm sure we all have vivid memories of watching on television as the rather unfortunate Lehman Brothers employees were filing out of the building tearfully carrying their boxes out. And for us to depend upon those records, you know, in a situation like that, ultimately to retrieve the value of our capital, our initial margin posted, would be of grave concern.

Our strong recommendation, if complete legal segregation were mandated, would be that the records of our collateral would, in fact, be independent, would be verifiable and available to us, and as well would stand up to an audit; that is, it would have to be created and shadowed by someone who is independent of the process that is not simply the FCM or the DCO.

MR. WASSERMAN: And I would note that in the futures model we currently have self-regulatory organization audits, and we of course supervise the self- regulatory organizations. And of course in Lehman, there were quite a few problems outside of the futures portion of the operation, but actually the futures portion of the operation went across to Barclays fairly seamlessly, so.

But Nevis, you had --

MS. BREGASI: I think I was just going to echo what Christine and Bill said before, that the complete segregation model will not add any extra time or cost to us when we put swaps into the cleared world.

MR. WASSERMAN: On the firm end.

MR. DIPLAS: I think from the dealer side obviously what has already been expressed in terms of what is required to be done is similar, because we have to do the reverse of what the clients basically expect. So, the implementation work is definitely there.

There is work that needs to be done on the personal side in terms of identifying basically the client IDs associated with the trades. Of course, for that information to be properly maintained and also taken apart in the event of default, that information has to be part of the trade, and that is not currently the case. So, I think that is something that we need to actually do, not alone but in conjunction with the DCOs if such a change rescue were to be implemented in a way that's going to be probably consistent among different DCOs.

So, there's going to be an issue of kind of standardization of how we're going to maintain that information, because, as I said, that is not currently maintained. And that perhaps goes back to the point that Mark mentioned also creating that the record that's going to be auditable and verifiable in the event of the demise of the SCM or the DCO in particular.

So, from that perspective, I think that there is a fair amount of work that needs to be done on the IT side, and it's not clear that right now all DCOs are equally ready to do so. Some people have already chosen that model; some have not. So, those who have not probably will have to do some of that work.

MR. WASSERMAN: I don't know if -- Oliver, do you have anything else to add?

MR. FRANKEL: No, not really. It doesn't seem like a huge amount of work in order to provide also portability on the back of that. I think that some templates need to be developed again by the DCOs, and so we would take the lead in getting that done.

MR. WASSERMAN: Folks on the phone?

MR. COCCO: Yes, it's Alessandro Cocco from J.P. Morgan, and we think that in the OTC framework we're getting the data. The roundtable is a very helpful opportunity to discuss these matters, but we are, you know, still working through the information that is necessary to provide a full feedback.

The situation in the OTC framework is

that for some clients we do provide the collateral held at a third- party custodian, but that is not, as far I'm aware, the majority -- what happens for the majority of clients. So, we absolutely hear the need for providing clients with certainty with respect to their collateral, so we're absolutely willing to work together with them and with the Commission.

But we think that there are some costs that we will have to face in terms of opening up a large number of accounts for implementing the complete segregation model. But, of course, if that is the way that the developments go, we will do our best to comply in the time frame allotted.

MR. NICHOLAS: I think that -- as a broker I think there, you know, should be an acknowledgment that moving to a complete legal segregation model would add another level of complexity to brokers, particularly joint broker-dealer FMCs that are already dealing with multiple segregation requirements, that this additional level of complexity will result in some increase in operational risk. I think that's just the nature of the game. I mean, more specifically, I can see potential changes to daily -- additional computations, perhaps additional monitoring, additional daily reconciliations, and, you know, perhaps changes in customer account documentation.

MR. WASSERMAN: So, what would you see in terms of additional calculations? I mean, for instance, with respect to the relationship between you and your customers, I assume you know, every day, the positions and contracts of each customer and do risk calculations and the like?

MR. NICHOLAS: Yes, absolutely, but I think the point is here you're adding another factor to consider. By moving away from the futures model, you're adding another consideration, another requirement that has to be followed.

MR. COCCO: Bob, it's Alessandro. May I add one point?

MR. WASSERMAN: Please.

MR. COCCO: One of the considerations that we've been focusing on when evaluating the four models has been the fact that based on the analysis we've conducted so far, there is a very significant difference for us between establishing the full segregation and the model that we commonly refer to as LSOC, the Legal Segregation Operation Commingled. And the difference is that the operational commingling aspect, really from a practical point of view, makes a very significant difference, and that's the difference between creating a single individual bank account per currency per legal entity fund versus having one omnibus account, which -- for instance, in the case of a transfer of positions for porting -- would not require the creation of several new accounts, possibly running in the thousands or hundreds of thousands of accounts.

Of course, one way to deal with that would be for clients to set up two clearing members and hoping that they don't both experience difficulties at the same time so that they can transfer from one set of very many accounts to the other set of very many accounts in the case of full legal segregation. But I think that it is a fact that the full legal segregation would result in very significant additional work when compared with LSOC, the futures model, and the fourth model.

MR. WASSERMAN: And so just to clarify, we are focusing on what had been called LSOC, which we renamed for good or for ill -- maybe for ill -- as complete legal segregation, the proposal does permit the operational commingling just as today. And as I say, it's -- yeah, we changed the name from legal segregation with operational commingling, because it seemed too much of a mouthful.

That being the proposed model, I guess the question is -- so you're permitted, in other words, to commingle as you do today. There's additional information that you would have to be passing up to the clearing orgs -- and we're going to be talking to them in a few moments -- but from the firm perspective, from my understanding -- and you folks will correct me, please, if I'm misunderstanding -- the biggest change from the firm's perspective is you're going to need to pass this information up to the clearing orgs every day. And so the question is from an implementation perspective -- that's obviously that nothing in this life is free -- the question is how complicated is that, and what are the steps you would -- more importantly, what are the steps you would need to take to implement that from the firm perspective?

MR. DIPLAS: Yeah, just to be clear, the comments we made were for what was formerly known as LSOC that you right now refer to as full segregation operational commingling, okay? So, otherwise the operational requirements would have been much more onerous.

So, we focused a lot -- you were correct to focus a lot on the transmission of information about the client account to the DCO. I think in terms of how onerous that task is, I think it is probably less onerous than what I think the buy-side mentioned, which is the documentation task is probably going to be the most important hurdle, bar none, and this is going to be secondary in that respect.

MR. COCCO: So, Bob, can I ask one question and then I'll be quiet for some time?

Are we saying that when the buy-side firms that spoke before express their support for complete legal segregation, that would be the model formerly known as LSOC, and so is the legal and operational segregation model not up for discussion today?

MR. WASSERMAN: I think there are probably at least some folks on the buy-side who would prefer the complete physical segregation. But I think the proposal that we're discussing and focusing on today starts, I mean, from the far end, if you will, with the complete legal segregation; and then after we hear from our colleagues, the DCOs, with respect to that, we'll talk about some of the other models. But they move, I think it's fair to say, in the opposite direction, that is to say, less protective and moving down toward the futures model.

MR. COCCO: Thank you.

MR. FRANKEL: Probably the easiest way to do it would be for the DCOs to keep a client ID on all trade records, and then the FCMs would only have to report daily the mapping from client to client ID and any associated credit multipliers or other information that would be necessary. That would be it.

MR. WASSERMAN: Which is a great segue to talking to our colleagues from the DCOs.

MS. TAYLOR: Okay, Bob. I think Edith wanted to talk.

MR. WASSERMAN: Yeah, Edith?

MS. O'BRIEN: Thank you, Kim. I think that member firms are actively trying to prepare for the final regulations that are released, Bob. I do think the challenges that were cumbersome as some as undefined or specified sections. So, for example, omnibus. I think that we continue to struggle with how we're going to handle omnibus accounts under this new proposed structure, specifically how do we have the data? How do we get to the data of the underlying client? This is something we currently rely upon our omnibus affiliate, that's a foreign broker, to maintain and handle. This isn't something that is readily transparent to US FCMs. I do think that is a major undefined, unclarified items.

I also think that there is the issue of portfolio and cross-margining. Is this something we can do? What would we have to do to prepare to implement this under the new structure?

Additionally, based on the outcome of those two, what is the amount of IT work that may need to be done in order to satisfy these requirements? Information is going to be, obviously, the critical component, how we communicate to the DCOs.

MR. WASSERMAN: Let me take a moment to speak to that. One observation I should make. So this is -- I know a lot of you have seen the proposal on the website. It's 190 typescript pages. I regret to say that our colleagues at the Federal Register have not yet gotten this published. I understand that they were about to and then their building lost power. In any event, to the extent -- and I'm certain there are at least some areas that are ambiguous and unintentionally so. You know, certainly we very much welcome comments that would help us essentially clarify ambiguous points and do so in a way that makes implementation of whichever of these models is ultimately implemented done in a manner that is as efficient and painless as possible.

With respect to the foreign broker point, I would note that these regulations speak to FCMs and DCOs. And so to the extent you have swaps coming through what we would, I guess in the futures context, consider from foreign customers -- and I'm not going to start talking extraterritoriality today, because that is an entirely different topic -- but however that ends up getting resolved, if you're having things come from foreign customers through foreign brokers, the foreign brokers are not subject to this. They're not FCMs, and thus they would not be obligated to pass information up on individual customers and thus the foreign broker omnibus we would not be imposing a requirement that there be individual protection.

Now, if the foreign brokers of course would be regulated in their own jurisdictions, and so there is I know -- and my understanding is in terms of EMIR and in terms of a number of the things coming in other jurisdictions, there may well be similar requirements, perhaps even more stringent requirements. I can't really speak to those here, because, again, that's imposed by colleagues in foreign jurisdictions. But from our perspective, we are not requiring anything of the foreign brokers, of course beyond the usual large trader things, which again are not topics here.

And in terms of portfolio margining, it seems to me that if you have essentially other things brought into swaps account, they would be treated similarly and so you would have, of course, the portfolio margining, and then the collateral would be treated the same way. And indeed, of course, arguably that provides some advantages in terms of seeking, say, 4D orders and the like.

But in any event, let me turn over to my colleagues, the DCOs. Kim?

MS. TAYLOR: Okay, Thanks, Bob, for having us today. I guess I would start out by confirming a lot of what some of the other panelists have said about the ease of implementation of the LSOC model -- if it's okay if I call it that -- the LSOC model. So, I think there will need to be changes to reporting requirements that we'll need to work out so that the FCMs can report to the DCOs the status of the accounts.

I think there might need to be changes to the 1-FR reporting process, as well as related to what needs to reported differently in this environment. It's a little bit unclear, but I think it certainly is workable. I think we might have changes to make to the way that we do settlements between ourselves and the clearing members, because I'm not certain that there is the protection for us to be able to net settlements and have those transactions stand. So, the legal certainty there is of concern to me, so we might need to change our settlement procedures. And I think we need to review our audit processes, possibly that affects the staffing, and possibly we even need to evaluate a cost pass-through model to the industry if the costs of auditing for this type of activity skyrocket. Right now those are costs we just bear as a benefit to the industry.

And as Edith mentioned, I think there are things that need to be clarified around, things like the omnibus accounts and some other items around the edges. But I think the overall summary there is that I congratulate the CFTC on coming up with a model with LSOC that is relatively easy to implement, and it seems that it would work pretty effectively on the average day. I think that it does not work effectively on a day when we really need it. So, the main thing that I think we'll be looking at and worried about implementing when we're looking at the LSOC model is I'll be at home going through all of my cookbooks looking for the recipe that shows me how to unscramble eggs, because that is going to be the position that we're going to be in, in a situation where we need to actually port the customers' positions. And I'm very, very supportive of the customers' desire to have their positions be portable.

And the gentleman from the GM Pension Fund mentioned some of the concerns about the maintenance of the records and the bankrupt entity and their ability to operate effectively in an environment like that. I think there are also big questions about what it means for a client to default, because the clearinghouse generally settles on a net basis across all of the obligations. Some of the clients are making money; some of the clients are losing money on any given day. And the clearinghouse settles with the FCM on a net basis for a net amount. If we settle for that net amount, then there is no protection for -- there's protection for the clearinghouse and having certainty around that payment perhaps, but there's no protection for the customers that were making money, because they were netted off against the losses of the customers who were losing money.

So, that leads me to think, okay, the better thing to do would be to separate out our settlement process so that we first make an aggregate call to the clearing member for all of the money of all of the customers that owe. And once we have certainty that we have received that money, then we make a settlement transaction for paying all the customers who are making money, and I think that that can work on a day-in and day-out basis where it becomes, I think, a little bit complicated even there.

On the day when the clearing member

defaults because of the activity of a customer that is shielded from the settlement bank's ability to know and it's shielded from our ability to know yet -- we don't know that anybody's defaulted yet, right? -- we send the transaction to the settlement bank. They're going to say yes or no to the entire transaction. Does that mean that all of the customers who happen to be on the same side of the market as the customer who caused the default have actually defaulted to the clearinghouse? I certainly think you can read it that way. Therefore, it will end up being a coincidence whether or not any particular customer actually gets the benefit of the LSOC model, because once a customer has defaulted to the clearinghouse, they no longer have the protection of not having their assets be used.

And then there is the complex. If I follow the chain right in the release, there's a complex web of going back to the first FCM and seeing if there's more money in the defaulting customer's account to be passed through the clearinghouse. Then, if he's not the original -- if it's an omnibus account or there's a non-clearing FCM involved, he goes back down the chain to see if that guy has money that he can send through, goes back down the chain to the foreign customer, and it says that you have to wait for an entire day before you know anything.

So, the problems that I have with the model are nothing to do with the ability to operationally implement it. I think that the concerns that I have are that it is unclear that it will effectively work and provide you with the protection that you want at the time when you need it. So, the unscrambling eggs problem is my biggest problem.

MS. MEDERO: Kim, I understand what you're saying, but the risk management rules for DCOs going forward are going to require that you receive gross margin from each customer. So, I'm having trouble reconciling your scenario of the net and who's on what side of the market, which should go to default with the fact that you will have gross margin.

MS. TAYLOR: Okay, I will have margin. I will have margin that is the aggregate of the margin requirements of all the clients. I was going to have that in the baseline model; I'll have it in the LSOC model; I would have it in the full physical seg model. I would have the individual client's margin right now, what the margin requirement was at the last time it was calculated, and I'll have the money for that.

But there's P&L. And it was really unclear to me in the release whether the P&L -- I mean, there was actually place in the release it said that the clients are entitled to their designated share of the funds that are being held at the clearinghouse as noted the end of business the prior day. And it specifically said with no effect being given to what happened to portfolio movements today.

Well, portfolio movements today are most likely to be the thing that causes large customer-driven default. Other things are more likely to cause a house-driven default, but portfolio movements today, an inability to pay your losses--

MR. MAGUIRE: Isn't it more likely portfolio movements yesterday?

MS. TAYLOR: Well, they've already been settled. Presumably they've already been settled, right? They've already been settled at the clearinghouse, so --

MS. MEDERO: I mean, I've never seen an intraday failure.

MR. WASSERMAN: I think your point on this score is that essentially -- let's assume everything goes well on Monday.

MS. TAYLOR: Mm-hmm.

MR. WASSERMAN: And so there are certain positions on Monday, and there is a certain amount of collateral associated with those positions as of Monday night. Then Tuesday happens and there's a final -- then the demand is made, which is supposed to be paid Wednesday morning, and it is not. And so then the issue is the last time you had a good settlement was essentially Tuesday morning --

MS. TAYLOR: From Monday night.

MR. WASSERMAN: -- as of Monday. So, that I think is the --

MS. TAYLOR: Okay, so the unpaid mark to market, the part that has been vectored in to the calculation, because the calculation of what you're protected on at the clearinghouse is static as of a point in time, and it does not include movements that have happened since that point in time until the point in time when the default is likely to be realized. That's one of the concerns that I have.

I mean, actually, I think, I question a fair amount that we really have a big problem to solve, because I think portability actually is very, very good in the current baseline futures model. I have the ability to port the positions of non-defaulting firms at the current settlement prices as soon as they can find a place to go or as soon as I can find a place to send them.

The money can't go right away. That is true. So, the portability of your positions is immediate and better in the baseline futures model than it would be with LSOC or certainly with LSOC with recourse. The only thing that would be equal or potentially better, because maybe your money can come with it sooner, would be the full physical segregation -- and I can't remember what we're calling that now.

The unscrambled eggs models I think create heightened uncertainty at the time when I am desperately trying to provide you with the portability and the protection that you want. But it seems as if, in reading these regs, I can't even act to take action until the close of the business on that day and if we presume the most likely time to get defaulted on is 7:30 in the morning.

That's a long time. But there's nothing I can do, because I have to wait for people to reach out to the FCMs and the chain and see if there's any money to be passed up, and I have to trust that that money is not actually sitting at the FCMs, who actually could be compelled by the CFTC regs to pass it up the chain.

That money is actually sitting in banks or custodians somewhere who know that the clearing member -- or that there's been a default, and as soon as there's a situation where the customer's name, the defaulting customer's name, is attached to some of that, I don't know that I feel comfortable that that will get passed on through --

MS. MEDERO: -- But that's the that's the issue in the futures models today, right? Does the custodian bank understand what its obligations are and do they perform? That's no change.

MS. TAYLOR: Well, I think it's -- I actually think it's worse, because I don't think I can do anything. Until I know which customers have defaulted, I don't think I can do anything to move the positions. So I think I have to wait longer. That's my concern. My concern is that I don't know that there's legal certainty. I think it will be hard to unscramble eggs. I'm very sympathetic to the issues that the gentleman from GM raised about that.

MS. MEDERO: But portability in the futures model without the cash coming with it isn't terribly satisfactory either.

MS. TAYLOR: And if that's the issue, then I really think that what we need to do is ultimately we have to have a model that works. It has to work for you; it has to work for the clearinghouses; it has to work for the FCMs. I think we ended up at LSOC, because there were lots of costs associated with providing for everyone a physically segregated account, but I think that we're actually in an environment where not every customer is as concerned as some of you are about being in a pooled spot. So, I think the model that might best serve the industry in terms of the safety you want, viability to deliver the safety that you want, and the clearing members' ability to manage the impact of it would be to have there be physical segregation but with an option so that only customers who really value the additional protection elect it. And that should mute the number of accounts that everybody in the chain has to bear the cost of, because the FCMs would have to bear the cost of all these accounts and the DCOs would have to bear the costs of all these accounts. Ultimately that means that you guys bear the cost of all of these accounts. But if only the people who really value the protection elect the accounts, it will be, I suspect, a much more contained process.

MR. WASSERMAN: And so I promise we will be talking about optional models in the next session, and we will get into that. But before we do, Kim, one very clear point. If anything in that proposal suggests that your hands are tied in terms of acting based on the information you have and the cash you have, and having to wait for something, then I think that was not what was intended, I will say by me, obviously, the Commission. But it certainly wasn't intended by me, and that's something that I would be delighted to work to clarify, you know, whichever model we end up going with in any final rulemaking.

MS. TAYLOR: It's good. I'm glad that you don't want to tie our hands. It's not just my hands. So, the -- but then I think we get back to the other thing that I am afraid, is that the customers will walk away thinking that they have a protection that they don't in fact have, because if the clearinghouse does not get paid on losses that are due and owing to it from the clearing member on behalf of the clients that owe money, the clearing member has defaulted. And I think by definition all those clients have defaulted unless they have in their account enough excess margin perhaps already with the clearinghouse that enough excess margin is allocated to them to pay for the losses for their share of the losses that day. Otherwise, I think that they have defaulted, because the LSOC model pools them all together for payments and so the clearing members are going to either pay or not pay, whereas the physical segregated model would require everybody to pay individually, but at least then it would be very clear who paid and who didn't. That's my dilemma.

MR. WASSERMAN: Fair enough, and I'm going to need to wrap this up. But let me just try and answer that point, which is so if the collateral is -- I'm a customer, and I am a non-defaulting customer in the sense that I have essentially deposited in my account at the FCM sufficient amounts. My position has associated with it a collateral requirement of a thousand dollars.

MS. TAYLOR: And what's in your account, a thousand dollars?

MR. WASSERMAN: Well, at the clearinghouse -- remember, you don't know what's in my account at the FCM and I can't make you responsible for doing that, because that would create all sorts of problems. So, from your perspective at the clearinghouse, I've got a thousand dollars. My position loses a hundred dollars.

MS. TAYLOR: Right.

MR. WASSERMAN: Now, ultimately, I'm going to have to pay that hundred dollars. I lost it. It's going to ultimately come to you. At that point, you owe me $900, because again a thousand minus a hundred. That hundred might be there at the FCM.

MS. TAYLOR: Actually, you owe me a hundred dollars.

MR. WASSERMAN: Right.

MS. TAYLOR: Because you have an obligation to have your position margined and have your losses paid.

MR. WASSERMAN: And so --

MS. TAYLOR: And either one of those things -- failure to do either one of those things is an event of default. If a clearing member does not meet a call for additional margin or a call for losses, those are both events of default.

MR. WASSERMAN: Absolutely, so --

MS. TAYLOR: So, you owe me a hundred dollars.

MR. WASSERMAN: I do, but essentially I owe you a hundred, you have a thousand of mine.

MS. TAYLOR: I do, but you owe me 1,100.

MR. WASSERMAN: Well, yes.

MS. TAYLOR: Right?

MR. WASSERMAN: Yes. Well --

MS. TAYLOR: Because you owe me the margin and you owe the losses.

MR. WASSERMAN: And so the one thing --

MS. TAYLOR: So, you're not even with me.

MR. WASSERMAN: I understand from that perspective. What I'm saying is you have the privilege -- and, again, I in my regulatory capacity as opposed to my customer capacity would not limit that privilege. If you'd look at the market and you say you know what, I just have to liquidate all of this, I think -- you know, and for reasons we've had comments on, that would be a very bad thing from a market perspective, but from a clearing perspective and from a regulator of clearing perspective, if you believe it necessary to liquidate that position, even -- heck, even if I had a gain that day, because it's not supported by a clearing member in good standing you have the privilege to do so. You retain the privilege to do so.

MS. TAYLOR: So, where's their protection?

MR. WASSERMAN: The protection -- and again that would be true in physical segregation, right? If we had everything physically separated, you have to have the privilege -- you know, until it transfers, until the transfer is accomplished, you're on the hook, the normal route in theory of clearing is every position is backed by a clearing member in good standing. My clearing member is not in good standing. So, you could liquidate those positions if necessary. If you liquidate this position, again we would -- you know, the ideal would be to allow for some re-margining at some point, which if, you know, again your hands are not tied, if you believe it is appropriate to do so and given what the market conditions are and the information you can get and the money you can get, you may choose to take that. Or you might liquidate the position, in which event, again assuming no further market change -- you have a thousand, there was a loss of a hundred. That 900 would then come back to the trustee, and that essentially -- in other words, I am not suffering the fellow customer loss. I may well suffer a loss from liquidation, but that, again, is inherent, and that's true across any model.

But let's continue this. I do want to -- unless -- well, okay.

MR. MAGUIRE: Thanks, Bob. I think, to just try and summarize this, what we're referring to there is losses incurred due to variation margin P&L, as Kim rightly points out. But that in play in all of the models that we have today. That's the same as gross omni or LSOC -- that's not an LSOC- specific thing.

When we started talking about collateral protection, this was about protecting the customer's deposit of initial margin in the first instance, that risk position so that we could lift it and move it to somewhere else, port it. All that variation margin stuff exists today in the existing market practice.

So, going back to the original question about, you know, what we'd have to do to implement this, first of all, from our standpoint I think you made it pretty clear in all the proposed rules that all clients have to be margined on a gross basis. Number two, DCOs and FCMs must keep records of client positions at the lowest level, at the client ID level. That's in the rules. That's not an LSOC-specific thing. That's a DCO risk requirement- specific item. So, from our standpoint as risk managers, we have to be able to see all the way through to the end client. So, we have to be able to see the client ID, to Athanassios' point. We have to be able to see through that, because at some point as a CCP we could face the risk that the FCM's gone, the client's gone, we have that risk; therefore, we have to go close it out.

So, every single day as the rules are proposed, we need to be able to calculate the variation margin, the initial margin, the risk for closeouts in default at the lowest level, at the client's ID level. That's what we're doing. So, that's just the cost of clearing. That setup has to be done. That's not an LSOC thing. That's not a gross omnibus thing. That's prescribed rules for the DCOs. That's what we have to do. And, quite frankly, as a DCO that's what we have to do. We have to be able to see our risk. We have to close it out in a Lehman-type event.

I think on top of this, to answer -- to maybe go to some of the concerns of the buy-side around this -- we will see your position in terms of risk, and we'll also -- what LSOC says -- or I forget the new name -- what LSOC says is we will take your position if you port, and we'll be able to give you the value of your position. So, the initial margin at the point of default, we'll be able to split each of the collateral amounts -- sorry, the omnibus amount -- split into equal chunks relative to the margin you had at the point of default. That's the collateral value. And we'll be able to lift and identify that and port you.

So, this -- I'm sorry to disagree with Kim on this, but I actually see this as we've unscrambled the eggs at the beginning so we can see this at the very start so we don't have scrambled eggs. We have segregation so we can see what the risk is and what the value of the collateral is. It's very different. It's a full set where we can see the piece of paper. But we can see the value of the collaterals. That's why I think this is essentially different. From an implementation standpoint, I think if the DCOs are obliged to calculate the risk at that level and have records at that level and, therefore, need the client ID at that level, they have to do this kind of infrastructure anyway. That's just the cost of clearing; it's not the cost of LSOC.

MS. TAYLOR: But that doesn't solve the problem of knowing -- absolutely we will know what the margin was in the account, what the risk was in the account, what the positions were in the account. What I'm concerned about is that when there are losses, we will be settling those losses at an aggregate basis by the clearing member. Therefore, if the clearing member fails to pay its losses, I think the read is that every client who lost money that day failed to pay their losses and, therefore, is in default under the definition of default. And so perhaps we can take the money that they owed in their default and take it out of the margin that we have, and if they very quickly move their money somewhere else they can move it short.

But I think there's also another complication that we didn't talk about, about the fact that the other thing about unscrambling eggs is that for operational purposes the current members are allowed to put up whatever collateral they want as kind of a pool, but we have to allocate value from the collateral to the individual clients in order to realize that value and because the clients share in what this characterizes the investment risk and in the risk of the haircuts not being sufficient. The liquidation of the collateral has to happen across everything, I think, in order to be able to move the funds with people, because you won't know what the pro rata share of the liquidation losses on the collateral are unless you liquidate the collateral.

MR. WASSERMAN: And key point on that -- in a bankruptcy what you're entitled to is value. I mean, essentially in an insolvency there is going to be liquidation. We have, of course, and you folks impose as do we, I think fairly good haircuts, but there is in the rule something that basically says in the event the haircut is insufficient, yes, those investment losses would be essentially allocated among the customers. So, I did want to clarify those points.

MR. MAGUIRE: Is that non-porting customers?

MR. WASSERMAN: Essentially what you're

allocating -- so, what you owe the customers is the collateral that's required as of the day before for the positions as of the day before to the customers whose information you will have gotten as of the day before. In the event that -- so, let's assume that totals a hundred million dollars. Let us further assume that the defaulting customer's allocated collateral is $10 million, leaving 90. Let us further assume that you have all the collateral as of the day before and that the haircut value was $101 million. But because it was 105 and then after haircuts $101, so it's more than 100. You liquidate it, you only get 98. So, we're not going to force you to allocate $100 million out of 98 million of collateral. That 2 percent you would be allocating among the collateral so that essentially we're not imposing on the clearing house.

Now, again, we're talking day over day, and so one would hope that this would be a non-event. But we did account for that possibility.

MR. MAGUIRE: Is that specific to LSOC or is that generally collateral for cleared derivative transactions?

MR. WASSERMAN: We made it clear for LSOC, I think, to the extent and -- it would work that way for LSOC. It would ultimately work the same way with recourse. And for the futures model it just would -- it would net out in the wash because that's all you'd be --

SPEAKER: It's the timing difference. So it applies to everything. It's a moment in time when that happens and when they port.

MR. WASSERMAN: And, Chris, I haven't -- okay, in which event what we have -- we may run a little bit over. I did want to talk about implementation timing, and so -- but we had mentioned in the release at least a straw man with six months from finalization -- from final rules being promulgated. What are people's views on doing that, and would that differ depending upon the model?

MR. NICHOLAS: Bob, when you say "finalization of the rules," are you talking about all of the relevant rules relating to -- or just this particular rule? I guess the reason I ask is I'm not sure that anybody can really assess the timetable necessary until some of these other rules are finalized and put into place.

MR. EDMONDS: I think there's got to be some coordination with the mandate going into effect, you know. So, I mean, it's probably not six months from the mandate, but whenever your mandate, which would, I think, at least encompass a majority of the rules, what we'll call phase I, what have you. But when you're going to make that mandate, that means those impacted have been defined, those exemptions have been defined, and those rule sets are in place. He's got to coordinate with that. Otherwise, we're not going to know whether or not we got it to where it needs to be.

MR. WASSERMAN: Let me press on that just for a second, because there may well be things -- and maybe you can tell me where there at least is a logical connection, but let's say for instance clearing mandates. And so that would certainly affect when you need -- you know, you are required certain things, but right now all of you folks are already clearing some things -- clearing some swaps, that is to say -- and so how would not having the mandate to clear other swaps affect the implementation of how you protect the collateral of such swaps as they are cleared?

MR. COCCO: Bob, may I make a comment? It's Alessandro Cocco from J.P. Morgan. We have devoted very significant resources to following developments on the regulatory front, of course, and this is a key priority for us. And we are, as you mentioned, liable in clearing for some of our clients, although we're open for business on that front.

It is a fact that we have been following developments, and the regulatory mosaic that has been introduced is very complex. So, we think it would be extremely helpful to have all of the rules published in their near final form, to have another comment period in addition to the one that's expiring today open again, because the impact of a rule of great relevance like the one we're discussing now can only be assessed in conjunction with the other very complex rules that are being introduced.

So, we really do think that whilst we're in favor with the overall perspective that has been introduced by Dodd-Frank and the regulatory activity that is implementing it, if what we want to achieve is great stability, we do really need to have enough time to understand the interconnectedness between the various rules that are being introduced and in practice how we are going to comply with them. So, I think that that will require time for us, speaking from a dealer perspective, to implement those rules.

We would like to have the opportunity to comment once all of the rules are finalized, because we are every day working on practically how we would implement them. And I don't want to speak from the buy-side, but I heard that there were some concerns, so of course it would be very interesting to hear their thoughts on this point. Thank you.

MR. WASSERMAN: Let me press just for a second on that. I'm going to put aside whether it's a good idea or not, you know, in terms to having further opportunity to comment on the rules as a whole, because that's really beyond my scope. But I guess the question I would have is let us assume, just for the sake of this discussion, that the decision is made that, okay, at the point -- you know, let's assume Thanksgiving -- this rule is promulgated. Let's further assume that some of these other rules might not be promulgated. I guess the first question I would have is which of those rules would you need to know the results of in order to be able to promulgate this rule? And I guess, second, how long would it take to implement, let's say, LSOC regardless of what the other rules are?

MR. MAGUIRE: I think I speak on behalf

of everyone. It would be nice to see the whole mosaic, but practically. LCH Group perspective, this -- we have a model analogous to this life in Europe today with clients clearing on every swap transaction. So from an infrastructure standpoint, we have it. If we say for clearing, we have to calculate gross. We can see collateral value. We can see the client IDs. So from our perspective, and we'll probably get onto the initial margin guarantee fund debate later, there's relatively no change. This is purely LCH Group, so we think it's something we could do relatively quickly.

MS. AYOTTE-BRENNAN: From our perspective, I think that we have been working, as we said, with the FCMs and the DCOs to try and figure out, you know, the reconciliation process and make sure our backup is comfortable. But I think from our point of view, we can't finalize that process until we have the final rule and until models at the clearinghouse have stopped moving after the final rules are promulgated. So, there is some lead time after the final rule when everything gets finalized by the DCOs and the FCMs and then flows down to the customer base so that we can finalize our tie-ins with those groups.

MR. WASSERMAN: That kind of lead -- I mean, is six months --

MS. AYOTTE-BRENNAN: No. We're thinking, as Bill I think said, you know, 18 months to 2 years to get all the tie-ins and the customer work done, because as asset managers, we now have to go back to all the customers as well and get all of those documents done. So, it's kind of a dual track there where we have to do the lead-in work -- we have to do the tie-in work from the operational standpoint, but we also have to do the legal work once we know what the final rule is, how the margin will be calculated, so we can understand that and explain it to the customers so that they will know what of their portfolio is being held as collateral by the DCOs and what might be put at risk.

MR. WASSERMAN: And so that's the

documentation, then, between you and your customers, which is somewhat separate from -- I think but tell me if you think I'm wrong -- this would essentially be the relationship between you or your customers and --

MS. MEDERO: They're going to sign those agreements, the futures agreements with the addendum. So, it's -- don't think of it as just the IMA or the pure arrangements. Today they open the futures account. The client opens the futures account.

MS. AYOTTE-BRENNAN: We as asset managers simply act as their agent. They are the principle on all of those contracts, so they need to understand what those contracts are and actually realize the liabilities or the obligations they have under those contracts.

MR. THUM: And I think it's fair to say that while overall we see this as a fairly involved long process. I don't think that we make a distinction that it will be longer if it's LSOC or full physical segregation. Perhaps if the futures model is used, we will have to have more engaged discussions with our clients about how their margin will be at risk in a way that it's not at risk in the bilateral world.

MS. MEDERO: Right, so in fact those clients who signed ISDAs are now going to have to sign futures agreements.

MR. THUM: Yeah.

MS. MEDERO: And we'll have to explain what that means.

MR. WASSERMAN: So, what I'm understanding is that is true regardless of whichever approach we take.

MR. THUM: That's right.

MR. DIPLAS: But I think you --

MS. MEDERO: It's a cost of moving to the cleared world regardless of how it's done.

MR. DIPLAS: You might have two different issues you're discussing here, I think, in the sense of the finality. There are also things fundamental for you to start your documentation process with the client, so I think that's a given, and that is what I was saying initially. How quickly we can move the implementation of the legal segregation regime or not could be a separate issue. And I think that is the six-month part that you were referring to, which I think -- six months for the Commission is very low.

MR. WASSERMAN: Yes.

MR. DIPLAS: But for that kind of implementation, I don't have a final number, but it seems to live within the low side from the standpoint in terms of the work, the IT work that needs to take place between, like, FCMs and DCOs, the testing, et cetera, and also even the agreements that we might have to do in terms of consistency, of how these reports should look, and how the client IDs should be done, et cetera, so that we don't have -- each DCO have a different methodology in that respect. So, instinctively six months seems low from that perspective.

MR. WASSERMAN: But what I'm hearing you say is six months may seem low, but not as low as compared --

MR. DIPLAS: I think the real constraining factor as I said in the beginning, is getting that final documentation with the clients. Even though some of the other work would be done earlier, at the end of the day they will not show up to clear unless they have it signed on the dotted line, and that's what is going to take the most of the time.

MS. AYOTTE-BRENNAN: Right, but we also have IT work, right? So, the six months for your IT work may be okay, but then on our side once that IT work is done, we need to do our IT work to make sure it ties in with the FCMs and the DCOs and make sure that the calculations that come through we can reconcile the margin calls on behalf of our clients, because today when we get a margin call from a broker, from our swap dealer, we don't simply pass on the money; we reconcile that margin call to make sure we agree. And so we will need to build those new algorithms into our systems to make sure that we can reconcile those amounts as well.

MR. WASSERMAN: I'm not sure I understand that, simply because the amounts of margin may change and we're going to be discussing those kinds of concepts this afternoon. But the nature of the margin that your clients would be paying may change when you move from the uncleared world to the cleared world. But the nature would not vary based on how in the cleared world it's going to be protected unless one of you folks thinks I've got -- I'm seeing heads nodding. So the nature of that margin won't change, the amount we'll discuss, and so your IT work would be to make clearing work but not to make LSOC versus futures model versus -- yeah, those distinctions would not be affected.

MS. AYOTTE-BRENNAN: Right, but what I've heard being said is that if we use LSOC, then we may have additional costs that may be put into the margin. And what I'm saying is that depending on what the final rule is and which model is chosen and how margin will be calculated, then we will need to make sure our systems line up with how it is calculated so we can verify the amounts.

MR. WASSERMAN: And let me make sure I'm not getting this wrong here. The amount of collateral required might change. The amount of fees that are imposed might change. But the nature of the two -- in other words, the margin is collateral, fees are fees. You may end up having more of either or both. But the nature of the two won't change. So, I think that's why, at least from where I'm sitting, I'm not understanding how that would require changes on your end. You know, again, to make clear -- to do clearing absolutely, but to do clearing where the collateral is protected one way versus another, I don't see that that would affect you from an IT perspective.

MS. AYOTTE-BRENNAN: No, I agree. It's to implement clearing. It's just that if we don't have the final rules and see everything together, then we can't do all that work.

MR. WASSERMAN: Absolutely.

MR. MACFARLANE: Bob, if I could just

add a slightly different perspective. Tudor would not be subject to or restricted by the long lead time that some of the other buy-side firms have mentioned. We would, in most cases, be able to participate as soon as the DCOs have made products available for clearing. And, therefore, we would ask that in implementation that whatever guidelines are established would be implement by as opposed to implement when, meaning that firms should be allowed to clear when they are ready, when their FCMs, their DCOs and they are ready. Additionally, we would strongly recommend that implementation not be phased by institution type, but be phased by product type so that buy-side participants and dealers could implement at the same time.

MR. DIPLAS: If I can comment on the other thing, in terms of the timing I think it's very important to remember that they also open client positions at the moment, so you need to be very careful that there's the one you will impose the mandate for the segregation to be in place.

Otherwise, you could be in the situation that current open positions might have to be closed down if the DCOs are not ready. If we said, just to give an example - if we said tomorrow we have to implement LSOC. Well, no, no, I'm exaggerating obviously. We don't have that. Therefore, these open positions would have to close down. And that's something that we need to basically make sure we work with you very appropriately. We haven't done all the operational work. That's why I was avoiding giving you a time whether it's six months or nine months or a year, and we need to do a lot of that with the DCOs and with all the market participants and give you that information before we can impose that mandate. As I said, with respect to the open position, with respect to John's point in terms of we -- do agree in terms of in general we want to make services available to whatever clients can use them. We do think, practical speaking, that the mandate for the dealers probably will have to go earlier than what happened to the rest of the clients just from the standpoint that dealers are already clearing and from a systemic risk perspective it probably makes sense to capture that large source of systemic risk earlier rather than wait till the last client is ready to do so. That's the only difference.

MR. MACFARLANE: Could you expand on that a little bit more? What's the rationale for sequencing dealers ahead of buy-side?

MR. DIPLAS: Well, from the standpoint of time to capture the largest systemic risk contributors, there is an urgency of getting the dealers, which actually probably from an 80:20 perspective are the largest systemic risk contributors. They are the ones, when they go under, I'm going to put them on the system that's stressed the most.

From our perspective, commercially speaking, we have the incentive to get our clients up and running as soon as possible. That's what we -- these are the services we are trying to sell. But we are also mindful that not every single client can actually get there at the same time, so that's why we won't have a system by which -- yes, we have a mandate on the dealers that will go in first. But from the clients who want to make the service available as quickly as we can for the clients that can actually afford to use the service and then have a mandate that actually takes into account the needs of probably the most economic resource constrained clients or the largest accounts set up.

MR. MACFARLANE: I guess all Tudor would ask is that whenever the dealers begin to clear, that clients be offered that same service by the FCMs, and those that are ready to clear can clear; those that are not ready to clear presumably would be offered a wider window to comply by. But to sequence to allow the dealers to go in first could cause a distribution of the critical mass favoring one DCO over another and remove from the buy-side the choice of where their transactions would be cleared. So, we feel pretty strongly that --

MR. WASSERMAN: And so with respect to when clients clear, that is a separate question outside the scope of here today. I think, for various bankruptcy reasons, among others, we are constrained with regard to whatever is cleared the protection for clients would be the same, could not vary based -- you know, if the client is clear -- every client that is clearing would be treated, you know, through a particular FCM, would be treated the same. We'd have to do that. The sort of sequencing I think you're talking about deals with when folks have to bring things from the uncleared world to the cleared world.

So, we've actually run a bit -- more than a bit overtime. A couple of things first. To the extent we've not had a chance to finish these things, and even to the extent that we have, it is very important and I very much encourage each of you and everyone out there to please put these matters in the written comments.

We're going to break I guess for about 12 minutes. I don't want to cut too much into our next panel. And so if we could reconvene for our second panel at 11:00. Again, restrooms down, end of the hall.

(Recess)

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MR. WASSERMAN: Ladies and gentlemen, if everyone can take their seats?

Okay. We have two new panelists who've joined us, and I'll let them introduce themselves. Kevin?

MR. FOLEY: Yes. I'm Kevin Foley from Katten Muchin Rosenman. I'm here on behalf of the FIA.

MR. KAHN: Hi, Ray Kahn, Barclay's Capital, head of OTC clearing.

MS. VEDBRAT: Supurna VedBrat, BlackRock global trading and market structure.

MR. WASSERMAN: So this panel is on the various optional approaches that we identified in the -- well again, the proposed rulemaking. And so, the first question I'd like to get folks talking about is how they would see an optional model implemented. And ultimately, I think we need to sort of get a little bit into the weeds to understand what are the challenges that would have to be met to get from not the optional online only, in theory, but in implementation.

Is there anyone who would like to start?

MR. FOLEY: Well, I will start. Let me emphasize that at the FIA, this is very much a project that we're just really at the start of. The firms have been -- although we've gone through the rules and are trying to understand them, there's no strong sense, I think, on the part of the firms that they understand all the implications of the words as they're written down.

As you were saying, Bob, there are things that maybe -- that you intended -- that the staff intended one thing and it may not actually read that way to others. And so there are things that we are going to have to take time to truly understand.

I do think from a bankruptcy point of view, we have an issue if we have an optional model that we need to kind of all sit down and really think through and make sure if -- is there one? And if there is one, how do we fix it if we can? And I -- when you say the optional model, I guess the first question is, is it optional on a clearinghouse by clearinghouse basis? Or is -- Kim mentioned earlier, can we allow certain customers who are prepared to pay a fee of some sort somehow to basically opt out of the customer seg requirements that we have and do something different.

I think you had alluded when you were talking with Kim that it would be very difficult on a client by client basis to allow that to happen within the bankruptcy rules and the bankruptcy code in particular. And I think that's right, too. But as I said, we all need to kind of think -- spend more time on that.

I think in terms of if it's a clearinghouse by clearinghouse issue, as was noted in the release, that might require each clearing firm -- if one firm wanted to clear three different clearinghouses, they would -- they might have to have three different FCMs each -- for each model -- a separate one for each model. And if you had the same customer who was clearing a CDS at the CME, interest rates at LCH, and energy at

ICE Clear, you would have the same customer at three different clearing firms. And that could be difficult.

So, I think there are operational issues, legal issues that would make that difficult. But then again, we all need to spend more time on it.

MR. WASSERMAN: And thank you for raising all of those issues. Given that you have, I think maybe we will take things a little bit out of order from the agenda perspective, and maybe it makes sense to first start talking about what the practicalities are for individual customer choice, if you will. And then depending upon where that goes, talk about some of the models that were more clearly discussed in the release, namely where there would be different models by DCO.

And so, there was some issue raised as to individual customer choice. And here's the concern I have, and I think we expressed it in the release. Which is the bankruptcy code 766(h) requires that distribution of collateral be ratable. And so, if we tried to say, well, okay. Some customers will have omnibus and they're subject to fellow customer risk. And other customers can pay a premium and they would not be subject to fellow customer risk.

So the first question, I guess in my mind, is, but then how does that comport or how can you make it comport with the requirement of ratable distribution? And relatedly, don't you have the danger that the folks who earlier said, oh, I'm not concerned about fellow customer risk are going to be going to the bankruptcy court and saying, wait a minute. Sorry, 766(h) says I have to get the exact same treatment as these other folks. And so essentially, there ends up being legal uncertainty there.

MR. MACFARLANE: Bob, in reply. If you have the flexibility in the rulemaking to accommodate both and institutions come to the same conclusion that you've pointed out and discerned out a risk, and they would lean towards LSOC, which would require presumably a lower level of margin. However, if with time the industry is successful in modifying the bankruptcy code, would it not be to the advantage of the marketplace to then have a mechanism that would accommodate the full physical segregation if customers chose to pursue that?

And I would just point out that you know, questions about the distribution of assets in bankruptcy have been dealt with fairly successfully historically by the industry. In the case of Repo in '84 post-Lombard law there was an amendment to the bankruptcy code. And similarly in the case of Swap Collateral amendment to the bankruptcy code. So, perhaps -- you know, providing the flexibility might give the clients both, you know, the opportunity to make their own -- come to their own legal conclusion and provide the flexibility if there was a subsequent change in the bankruptcy code to move to full physical segregation.

MR. WINTER: I would say as it relates to the optionality, I don't think it's a question of are you doing it by DCO? I think it's a question of between a client and its clearing broker. And that's where the optionality should be.

Recognizing that at the end of the day, if you look at the clearing model today it's open spoke model. In the center of that, you have the DCOs. On the outside of that you've got the FCMs, and then the FCMs have the relationship with the clients. So I think that's the only way you can actually make that work.

MR. WASSERMAN: And so, with respect to John's point, at least for the current rulemaking we've got to deal with the bankruptcy code that we currently have. If there is a change in the bankruptcy code, then one can reconsider things.

The issue with respect -- given that what we're talking about is an insolvency, ultimately the FCM is going to be in a position where it doesn't have the ability to meet its obligations. And so then the question is, in terms of any distribution or in terms of any transfer which, essentially, accomplishes a distribution otherwise -- given that there is a requirement of ratable distribution, my concern is, again, in the current bankruptcy code and until it changes, the concern is how can you -- you know, even if the -- whether it's the FCM or the DCO or even our regulations say well, okay. These customers will be treated differently.

Ultimately the question before the bankruptcy judge is, okay were those agreements -- I mean, agreements are overturned in bankruptcy court every day. That's the nature of the exercise. And indeed, my fear would be that the judge would say, how nice, CFTC, that you have this rule. Unfortunately it does not comport with the code, and I'm enforcing the code.

I mean, we have, indeed, a number of powers under the Commodity Exchange Act and under the bankruptcy code which protect things in ways that other creditors are not.

MR. EDMONDS: So, Bob. Is it your interpretation that there's no way either through rule set, documentation, or regulation that this agency controls? That ratable distribution by class could be put into place without that material change?

I mean, we're going to be dealing with a lot of things that don't provide absolute certainty as we go through this. Hats off for, you know, the work that's been done to try to get to that point. But there's still some that we're betting them to come with us a little bit.

But if it were clear -- and obviously, there are ratable distributions based on classes in bankruptcy a lot. Why would this be any different in that case if we wanted to provide a way for folks to either have it or not have it? And it included the documentation between FCMs and their customers, documentation between clearing -- membership documentation between the DCOs and the clearing participants, and then codified in the rule set that this commission can control.

MR. WASSERMAN: And so, we do -- you're correct. We do have, for instance, account classes. And so right now we have separate classes for futures, for foreign futures. We've added, of course, just over a year ago a specific account class for cleared OTC.

But all of these have followed, you know, ever since the late '80s -- and we sort of discussed this a little bit in the release. It's in the footnotes, but. Since the late '80s, all of these have been based on the type of the product. And indeed, they draw sustenance from some legislative history of the bankruptcy code saying that, well, you would have different estates based on the type of product.

And so futures are a different product than swaps, and futures -- there's important differences product-wise from foreign futures. To then take the leap and say, well, okay. Each person his own account class. Or, customers who elect this are in a different account class from customers who don't. That, it seems to me, is a much further step than ever we've taken.

And yes, some of -- well, I'm not sure I agree that we're looking at that things are -- we're sort of taking gambles in terms of the interpretation. My colleagues from OGC would be very upset with me if I agreed with that. And indeed, I think they're right that, essentially, we are trying to interpret the law as best we can. And I guess from where I'm sitting, I don't see how you can interpret ratable distribution and account classes to get there.

I guess there would be a separate issue, which is -- so we start out saying, well, gosh. Customers can pay more and then they would get something better. And if there were an insurance company out there who is offering policies on fellow customer risk, then maybe we could get there. But I'm not aware that there is one, so then the implementation question I would be asking is, so the customer pays more, okay. Who are they paying it to? And how at the point at which you need the money does that translate into protection from fellow customer risk? In other words, if the customer is paying money to make someone else bear the risk of loss, great. Who is that person and how are they going to do that?

MR. DIPLAS: We tend to agree with your interpretation. I think our -- you know, we need to do a little bit more work. But our read of the current -- the code as it stands is that we probably need to offer these services out of different FCMs. We have to create different FCMs -- capitalize them separately to offer one segregation versus another, for the clients to feel comfortable that they will get the treatment they expect in bankruptcy.

To continue some of your questions, you could say I could go -- if I'm a client, I could go with the -- you know, like a commingled model until three days before default, and the last two days convert to the fully segregated. And of course, everybody will do the same and there will be nobody on the other side.

So, I just don't know how it operates. I think you probably need to create these kind of silos if you were to offer basically -- if you were to offer --

MS. TAYLOR: If you were to offer choice by clearinghouse --

MR. DIPLAS: Choice by clearinghouse, yeah --

MR. MACFARLANE: But Bob, what's the downside of offering both and allowing the individual market participants to make their own judgments about the bankruptcy code or the risks associated with one model versus another?

Because if you don't offer both, then you really rob the opportunity to perhaps take some initiative with respect to the bankruptcy code or address that problem that full segregation may present in different ways. So, it would seem -- you know, you're not weakening the system. In fact, we would argue that you're strengthening the system. And we're concerned about the systemic consequences of omnibus model and the mutualization of risk that that creates. It really under-prices the distribution of credit in the system.

And so, there are other systemic reasons to think about the full segregation model and to try and work in a way to make it practical.

MR. WASSERMAN: Again, unless we can be convinced that there's, you know -- if not legal certainty, at least some very, very strong legal arguments that would support the non-ratable distribution than to simply say, well here's a model out there. We don't think it's going to work, but hey. It might. I'm not sure that's something that would be responsible for us as a regulatory agency.

Because I fear -- my experience has been when bankruptcies happen -- you know, before bankruptcy everyone says, well gosh, don't worry about those risks. We've got it covered. And we don't want to have to pay to avoid them. We'd much rather have this or that.

Post the -- when the bankruptcy happens, then people forget all of that. And then the question is, well, gosh. Why didn't you set this up in an airtight fashion? And so, I think we need to set it up in a fashion that we believe is reasonably airtight according to the law. And yes, if there is a change to the law that would make -- you know, then we could look at things differently.

Although again, the question I still would have on the table is, okay, great. You're paying more. Who are you paying it to and how -- who is bearing the risk? How is the client paying more convincing someone to bear the risk of that fellow customer loss? You know, how are you going to calculate it, how are you going to pay for it? You know, where are the arrows go from customer pays money to customer gets money back?

MS. TAYLOR: Hey, Bob?

MS. VEDBRAT: Bob, you know, when you mentioned paying more, are we making that reference from the baseline model? Because like, you know, the OTC market today for customers that have opted to, you know, engage in a tri-party agreement, they already have a cost associated with it. So it's more a transfer of that payment into the cleared world.

You know, the other piece is that, you know, our discussions with LCH has indicated that the LSOC model itself should not actually have any additional costs to clients.

So, if we can just -- I mean, the costs -- my questions was more, is it, you know, additive to what an OTC client has selected today in a triparty? Or are we talking about like a wider audience here?

MR. WASSERMAN: And I think you make an excellent point there, that there are costs already that are incurred today in the un-cleared markets that, in terms of the difference.

But what I'm talking about here, I think, is if you're saying, look. Some clients will pay less and have less protection. Some clients will pay more -- in a cleared model. Some clients will pay less and have less protection.

I think the theory of -- and Kim, you'll -- I'm going to give it back to you in a second. If what you're saying is, well, look. Some clients would pay less and have less protection. Some clients would pay more and have more protection. My question would be, okay. Put aside for the moment how much more. How do you get from the client paying more to the client getting the protection? And what happens -- who is bearing the risk of loss?

MS. TAYLOR: Who's bearing the risk of loss in a shift? Because both of these models are a shift. They're -- the LSOC model is a shift. The full physical protection is a shift.

To the higher chance that there'll be a mutualization. And you can manage that, to some extent, with higher margins and with concentration margin. And you can do all of that. But ultimately, all of those things are an estimate of what you think the worst case loss would be. And the estimate could be wrong, and a clearinghouse would be irresponsible not to have enough resources available to be able to weather the default of its largest participants and its biggest loss at a time when the estimates were wrong.

So, all of these are a risk shift. So if it's -- I think you're trying to make it like a matter of fairness, like it's unfair that some people would pay more and get better protection. I think I would look at it a little bit differently -- and I'm kind of going back to Chris' question about account class. There is an account class for -- pretty sure there's an account class for deliveries. And deliveries -- they are not different products than futures. They are customers who took the option of going into delivery, whereas other customers did not take the option of going into delivery. And there's a provision in the code now for those two sets of customers to be in different account classes.

So, I don't really follow why there couldn't be a case where customers took the option of pooled segregation and customers took the option of individual segregation, and those could be also different account classes. I don't quite follow the logic.

MR. WASSERMAN: So, two things. Well, actually three. I'm really not talking about it in terms of fairness that -- well, this one paid more and this one paid less.

The issue there is, you know, the ratable distribution requirement to the bankruptcy code and how you get around that.

MS. TAYLOR: But it only goes to an account class.

MR. WASSERMAN: And in terms of --

MS. TAYLOR: Right?

MR. WASSERMAN: Right. But and so in terms of making that a separate account class and the delivery account class, yes, indeed, delivery is a different account class. Of course, customers who are in delivery -- I guess I'm not sure that I would look at it as a different option. Rather, they're in a different stage of the contract.

MS. TAYLOR: But they opted to go there, right? They took an option that other clients didn't take in the same product set, and they ended up in a different account class.

MR. EDMONDS: Still a conscious decision.

MR. WASSERMAN: But customers make conscious decisions every day to maintain their -- you know, by that same token customers make conscious decisions every day to maintain their positions. And so by that token, again we could have everyone their own account class. I'm not sure that that logic is legally strong in terms of saying, okay. This is a different product. Rather, again, the delivery is, I think, looked at more as a different stage in the process. And essentially, as long as you don't liquidate out earlier, that's where you are.

MR. NICHOLAS: Bob, what I would say is -- I mean, it seems like as the gentleman from the buy side said, this is something of interest to customers. And if that's the case, then I think it should be looked at and pursued.

That said, I'm not sure the timing is

right for the optional approach at the moment. Until, as you say, the legal certainty on the bankruptcy side is a little more well-established. And I would also maybe just add in that the -- just the complexity right now. The whole mosaic of the changes. It adds yet another layer of complexity.

I think one case which is a little bit illustrative is the case of single stock futures. I think in that situation, clients do have a choice, I believe, in terms of whether they want a securities protection or futures protection, which are clearly different bankruptcy regimes. But I think maybe the difference there is that there is some certain -- there is certainty. I mean, they're different but you know what you're going to get. Whereas I think in this context, as you said, you don't really know what you're going to get.

Ultimately, you know, it may be that people have to go back to Capitol Hill and hash this out and have something developed in the bankruptcy code to provide that certainty. And at that point, then I think, you know, it is something that should be looked at.

MR. KAHN: I'd like to add in the concept of optionality, there's a set of clients that we've been speaking to that have said, we really -- we don't have optionality.

Our clients expect us to have the highest level of protection. So even if we would like to stay at the -- you know, the lower level for return basis or cost basis, they don't have the optionality. They have to choose under their charter or bylaw. And they have stated as a concern that, you know, what we've been talking about is some sort of free riding, you know, that as a stronger credit or as a pension fund or something like that that they are allowing others to not select into the highest level of protection. And that has been expressed to us.

MR. THUM: Well I think as well, assuming there could be separate account classes set up or separate customer account classes set up, and assuming people could make a choice, at the end of the day the DCO has to establish margin levels that will meet the risk presented in each bucket. So, for the bucket that is the LSOC model, presumably the margin levels would be higher. Perhaps the guarantee fund might be higher, things like that. In the futures model, the margin levels presumably would be less.

But I think that one thing that we have to consider -- and I think it's brought out in the release -- it's been mentioned by LCH, it was mentioned by Athanassios -- is, in that bucket -- in the futures bucket, will clients stay in that bucket as the FCM starts to weaken?

Clearly, the clients can assess their fellow customer risk. They don't -- other than understanding how the FCM makes its client decisions. They cannot assess the fellow customer risk. But they can assess the FCM itself. And while -- if the assumption is that we're setting lower margin levels because we have access to the overall pot of collateral. But then the overall pot of collateral is diminished, how is that a sustainable model?

Vanguard, of course, will opt into the LSOC model if it is a choice. If it is not a choice, for many on the buy side it will involve a much more engaged discussion. If there is a choice, it will be a much more engaged discussion with clients to explain the risks. And we'll have much greater disclosure, I would think, obligations. But Vanguard and for Vanguard funds, would definitely pick the LSOC model.

But I think, you know, once you get past can we set it up so that it works or a bankruptcy co-perspective, and will clients make that choice, is it an actual sustainable choice that will protect both buckets?

MR. MAGUIRE: Bob --

MR. COCCO: Bob, it's Alessandro Cocco. I just wanted to say that I think that the bankruptcy law issues, of course, need to be resolved. And the question of optionality is linked to the question of the timing that we had in the previous session.

So, I think from a timing point of view there is a difference between the various models being proposed and the futures model. Because in the futures model, I think from what I hear from my colleagues in operations, it would be easier to just implement what we already do for futures.

LSOC would present some differences, so even though we're still assessing them they're probably of an order of magnitude that can be dealt with. But they're more than zero. LSOC with optionality would require wealth -- from a personal point of view, I think it is a very attractive idea. Whenever I check with operations and we are doing the work to double check this, it would be requiring a significant amount of work because now you need to track who opted in and who opted out. And then to, finally, the full operational segregation model from a timing point of view would require a lot of work.

And so, I think that we -- again, we are doing the work to come up with more precise estimations. And we will either directly or through the trade associations file our comments. But you know, finalizing the comments on the timing period. I think that anything under one year would be extremely problematic for us.

MR. MAGUIRE: Bob, I think just to frame this. Are we trying to make this operationally easier? Are we trying to make this better risk protection? Because a lot of it's about implementation.

I think introducing the cost and the margin is relatively motive, because we're going to talk about that later. And there are different views from different DCOs on this. I think what we're talking about is protecting those who chose LSOC versus those who chose the -- if you're the futures model. And how can we bifurcate those two from each other under the bankruptcy code?

The cost and margin will come onto, and hopefully explain in greater detail later. But the only way we can really see this can actually work is if you have one customer type, if you will

-- the LSOC going through -- an FCM. And then, the other -- the omni going through another FCM at the overall same firm.

Now, I'll let the FCMs comment on what that means for them, because I'm sure that's quite an overhead encompassing undertaking. But the only real way to do that is through account class, go up a level and do it at the entity level. So you have two separate FCMs so they all, if you will, divorce from each other. So you could have a LSOC FCM with the OTC class and you could have an omni OTC class FCM as well. And therefore, those two things should be potentially divorced from each other or bifurcated.

MS. VEDBRAT: I think also, Bob, you know the selection of FCM is also dependent on the optional model that might be presented. Because if it's an omnibus structure, you may -- we may request for an FCM to provide a parent guarantee of some sort. Or like, we may want to deal with an FCM where there's -- you have a known pool of clients.

So, that needs to be considered.

MR. WASSERMAN: And so to be clear, the proposal mentioned as one optional model. Essentially, yeah. Splitting the FCMs. That is to say, so I don't think it would be practical under this to say, have an FCM deal with one DCO that, let's say, does the futures model, and another that does the LSOC model. Because if the default happened with the FCM that did the futures model, then the customers who thought they had maybe only dealing with the other DCO -- which has the LSOC model but under a ratable distribution they would be very surprised and disappointed to see that it is, in fact, ratable.

So, the proposal -- and I want to, in a few moments, get to --

MS. TAYLOR: You're going to mix account classes now across FCMs?

MR. WASSERMAN: To be clear -- okay, forgive me. If you have two separate FCMs -- well, if you have one FCM and they're dealing with two different models, my point is that does not work because if the FCM becomes insolvent and if the insolvency is caused by a loss at the DCO that undertakes the futures model, then ratable distribution would mean that customers -- even customers who are only dealing with products that are cleared at another DCO that does the LSOC model, they would still be suffering losses. And that would -- so that is impracticable. That does not work.

MS. TAYLOR: Without a separate account class.

MR. FRANKEL: Well, the futures model being the baseline model for cleared swaps.

MR. WASSERMAN: Yeah, the pure omni.

MR. FRANKEL: Yeah.

MR. WASSERMAN: And yes, unless the account class were to work -- and as I say, at least my legal analysis and, you know, very much invite comments with a detailed legal analysis as to why the account class would work. But for the moment, I guess I'm thinking that the account class does not.

What the proposal was -- and I was instructed, okay. But try and come -- you know, can we do -- what room for optionality is there? And so, if you said, well, look. Each FCM has to be uniform, homogeneous. They only deal with DCOs that all do the same model. So you can have one FCM that deals with DCOs that do the LSOC model, and a separate FCM that deals with DCOs that use the futures model. And again, you know, they would be -- they could be affiliates. But they're separate legal entities.

Then, the distribution from the one doing the futures model would proceed in accordance with that, and all the customers there would get that kind of distribution. And the distribution from the FCM doing the LSOC model would proceed in accordance with that model. That is mentioned and questions are asked in the release. That is a place where the Commission could go.

And so the question here is, if we went down that path what are the implementation issues?

What are the practicalities?

MR. NICHOLAS: One question on that through, Bob, is -- maybe I'm misunderstanding. But isn't part of Dodd- Frank gives the customer the ability to elect which DCO to go to? And how would that -- if they elect to go to one that doesn't have the protection that that FCM wants to -- it provides?

MR. WASSERMAN: And so, I'm not sure that the -- I mean, if an FCM. So, you know, put this issue aside. Answering your question.

If an FCM clears, let's say, at CME and ICE but does not -- is not a member of LCH. And I as a customer come to that FCM and say, well you know, I want my swaps cleared at LCH. I don't think they would have to say, well gosh, okay. We better get that clearing.

My colleagues may disagree -- and don't hold me to this -- but I think there would be some practical issues with forcing an FCM to go to a DCO and become a member. Let alone the DCO may look at the FCM and say, sorry. And again, separate issues there. I really don't want to get into the open access issues.

But in any event. So, if you then said, okay, instead of saying well, sorry. I don't clear with that DCO, the answer might be, well, yes. But my affiliate does. So I don't think that's a practical barrier to implementing things this way.

MR. NICHOLAS: But that's assuming there's an affiliate. I mean, not all FCMs are going to be able to have multiple affiliates.

MR. WASSERMAN: Yeah. And well to be clear, that's one of the questions I'm asking.

MR. NICHOLAS: Right.

MR. WASSERMAN: What are the practicalities if we tell the FCM, look. Right now you're one entity, one capital pool. You know, one form 1-FR. If you want to proceed on because different DCOs are adopting different models, you're going to have to sort of hive off and have separate FCM. Is that practical? I mean, there are some folks who have told me yes, and there's some folks who have different views. And I'd like to hear what folks around the table here think.

MR. NICHOLAS: I mean, just real quickly. I mean, I would say it could present capital resource issues. You know, FCMs don't have necessarily unlimited amount of capital. And now you're splitting it in half. Resource and staffing issues also come into play.

MR. MACFARLANE: But why wouldn't we let the market decide? I mean, if some FCMs decided to bifurcate and offered to FCMs one which integrates with DCOs providing baseline, and the other one that provides LSOC and let them, the clients, decide which they choose. And you as FCMs can compete with one another. Some of you may chose a monoline structure, some of you may choose based on your survey of your clients a bifurcated structure.

MR. COX: I mean, I think if you want to go down this road, presumably what you're saying is that each DCO would actually have to offer both approaches to fellow customer risk and then FCMs would decide which they were going to offer. And there would be some banks would have two FCMs, one for one kind of margining and one for the other.

Which, I mean, it's not unusual, right? A lot of banks used to have these triple-A entities for doing -- you know, over the counter bilateral swaps. If you wanted to do a swap at Bear Stearns, you could trade with Bear Stearns single-A or you could trade with Bear Stearns whatever it was, triple-A thing. And there was a different price for dealing with Bear Stearns triple-A. I don't know if any of those still exist, but it's not really a new concept.

MR. WINTER: Bob, I'd like to go back to a comment that you made, though. And you can't separate out the issue of the open access. Because if you start separating FCMs into more than one, they're going to have different capital structures. And then what's going to happen when, you know -- particularly if one of those entities doesn't have a trillion dollar open book to be a clearing member of LCH? Then they can't compete in that market. So that creates problems.

So, you can't separate the two issues.

MR. WASSERMAN: So what I understand you to be saying is essentially because you're separating them out, essentially now you have two capital pools, it makes it that much more difficult for clearinghouses, then, to accept these now smaller FCMs.

MR. WINTER: That's one of the side effects that can come out of that. That's correct.

MR. DIPLAS: But I think this is -- we're making the assumption that this is past the finalization of the rules to respect the membership requirements and all that stuff. So we're going to know what the barrier is.

I think your point before was valid, in the sense that if a client comes to me and says, I want to clear at LCH but I'm not a member at LCH. Well, I'm not available for that. I can become a member, and this is not going to be any different.

I think the part we agreed is that we think we would need multiple FCMs.

So, there is a capital constraint there, I would agree with John's point. That it's not necessarily the most efficient. But I think that would be the facts that we're going to face at that point.

There might be 10 FCMs here and 6 FCMS there, or -- and so, clients might have fewer FCMs available than the total net that is available now. But that would be the choice, I guess.

MR. KAHN: I think you have the issue of capital efficiency is important. But you also have the issue of resource efficiency, basically at a time when the industry is trying to get clearing to go live. So the question is, how many resources can each FCM, DCO put aside to basically establish this two or more FCM structure?

And then the other question is, how many buy side clients are going to use it? Are we going to establish something that then is only used by a very -- one or the two is going to be established by a very small percentage of the industry. And was it worthy of basically taking those resources and dividing them? And also, whatever costs there are -- which I obviously am not prepared to speak to. But it's an issue of timeliness to market, and along with capital efficiency.

MR. MACFARLANE: We have to be careful, and I think Chris -- rather, Dan said it well. That we're not overly expeditious and trying to optimize or minimize cost as it relates to collateral and operational cost. Because that may drive us to a conclusion that systemically puts -- makes the system more vulnerable.

And an example would be, if we systemically under collateralize, we choose an omnibus model because it results in the lowest amount of collateral. Then, you inevitably are going to -- there would be a misdistribution of risk because you're asking counterparties to put up less collateral than they would otherwise have to put up if they were margined individually, because they're being co- insured by the others in the omnibus pool.

And if we do that, inevitably there will be an institution that will take all of that -- all of that runway that's given them to take risk, and over lever. And putting the system more at risk. So, we shouldn't be afraid to properly collateralize on a stand-alone basis transactions. Because that's how you're going to properly allocate risk within the system.

MS. VEDBRAT: And I think we also have to consider, I mean, the small set of -- there are a small set of clients that do require segregation. So, you know, as we move to the cleared role we cannot, like, take a solution where we basically eliminate them out of the market.

MR. DIPLAS: No, I think we all agree on that. I think perhaps Ray's comment was -- if I give you an example. Let's say there are 20 FCMs now. And if, for argument's sake, 18 of them decide to go with model 1 and only 2 with model 2 and 1. There is a situation that clients might end up only having a choice of two FCMs in that case, if they want to chose model two. So there is a bit of an issue in terms of whether -- yes, they try to make this investment decision and trying to be there, you know, on time as to how many of them would be able to offer both services at the same time. It's going to be a question of -- there's going to be some guessing in terms of how many clients will actually chose model one versus model two.

MR. SZYCHER: Well, on that particular instance, seemingly model two is not something that's being supported by the marketplace and will probably simply fade to black.

Just, I guess, kind of a quick comment, you know, with respect to what Ray had mentioned. You know, of setting up, you know, multiple legal entities. I realize there are, you know, capital considerations. But as far as operational personnel, I don't think anyone's suggesting here that we've got, you know, a distinct set of people who are working for, you know, FCM A and, you know, the two versions of, you know, let's say Barclay's FCM. You know, as you know, all your banks have, you know, literally hundreds of legal entities that are set up. And generally speaking, we're all working for, you know, a multitude of those at any given time. So I'm not sure the challenges of those are necessarily as -- that hurdle is insurmountable.

MR. COX: Of course, in that example your choice of two FCMs is still better than a choice of none, which is what you'd have if no one offered choice number two.

MR. EDMONDS: Bob, I want to go back to what I think I heard you say a little bit earlier. You said the Commission could go one direction where you could choose to have the option or some option around the LSOC piece. If you could get to that point, why couldn't you also have optionality around a more complete segregation model? And have that same separation. Did I misunderstand what you said?

MR. WASSERMAN: Yeah, I think what I was talking about is that -- and we may disagree. And, you know, I really look forward to the analysis and the comments on the legal issue of having it by the customer. But if you do it, then, now by DCO, I think the question then is not simply a practicality of, well -- so even if one DCO says, well, fine. We'll offer complete legal segregation.

I was less -- the concern here is if you do this by DCO where each DCO is dealing -- or rather, each FCM is dealing with DCOs that are uniform based on model. And yes, that model could be full physical segregation. Although again, I'm not sure that helps given that you've got this ratable requirement.

But what a number of folks seem to be raising is, in order to have, then, right now one FCM can deal with all clearing organizations. You know? So long as the clearing organization will accept them, they've got the operational infrastructure. A particular legal entity can deal with all clearing organizations.

Under this approach, you would only -- you couldn't have -- if different clearing organizations adopted different models, then the FCM would have to split off so that it would have one affiliate that deals with those clearing organizations that, if any there be, that adopt the LSOC. One affiliate that deals with those clearing organizations, if any there be, that do full physical segregation. One affiliate that deals with those clearing organizations that do the futures model.

And so, that kind of splitting off, I suspect and what a number of folks seem to be suggesting is, there are some disadvantages there. There's some concerns in terms of the practicality because you're taking what was one entity and one capital pool and splitting up the capital pool into smaller pieces.

MS. VEDBRAT: Bob, on the DCO side. You know, I think, you know, we'd have some concern if you were to have DCOs that opted, you know, one model or another. Because that's going to impact liquidity on the front end. And that -- you know, that we would like that to be a consideration.

MR. WASSERMAN: Fair point. Let me ask -- just focusing on the DCOs. Because I don't want to presume what folks are going to do. What criteria would you rely on to choose a segregation model? And how would that decision be based -- you know, if at all -- on choices made by other DCOs?

MR. EDMONDS: I mean, I -- from our perspective it's going to be risk-based, right? It's going to be our evaluation of the risk associated with that model that may or may not be prescribed in the rules. I mean, you're giving us a hypothetical that there may be some menu of choices that we could take, and we'd do that on a risk- adjusted basis, full-stop. And then, you know, after that risk evaluation is done, what can we do to commercialize that for our shareholders?

MS. TAYLOR: I mean, I think in our case it would also be a risk-based evaluation. Based on setting the right balance between customer protection on the one hand and systemic risk containment on the other hand. And I define that as the ability to stop the default of one clearing member to bleed through and adversely affect the other clearing members. That's a very important element of what clearinghouses do and the way the customer protection mechanism is set up. And the risk management protections you put around that affect that.

As -- and you know, I think I made myself pretty clear in the beginning here that the legal certainty around how things are going to work at the very worst point in time is going to be a very important part of that. Clearinghouses do not have the luxury of waiting to find out if they're going to get paid. And so, our timelines are very tight. We issue instructions and get paid within an hour. And if someone doesn't pay us, there is a default. And that needs to be acted upon, because if it is not acted upon we are creating undue and potentially unnecessary risk that is going to be imposed on the other clearing members who are meeting their obligations.

So, that's -- it's finding the right balance between serving the customer protection requirements -- and we are very sensitive to the customers getting protection that they feel is valuable to them. But also, balancing the systemic risk containment.

MS. AYOTTE-BRENNAN: Bob, I think from an asset manager's point of view -- sorry.

MR. WASSERMAN: We'll be coming to you guys in a second. But if we could let Dan --

MR. MAGUIRE: Okay, I'll be brief. Risk-based and default management practicality would be priority. But you know, moving down it would be also customer demand. And their clearing member's ability to be able to offer these services. And then, let the market decide, you know? We are not averse to offering growth only LSOC and other account classes, if they're allowed, or other account styles. But it won't be necessarily what the other DCOs are doing. It's more for what the clients are choosing and the clear members can offer.

MR. WASSERMAN: Let me talk, then -- as a question, then, for the clients and the firms. And basically, if the DCOs are allowed to chose, do you anticipate that there would be different models chosen? And if different DCOs make those different choices, what do you see as the factor in your ability to chose a clearing model?

MS. AYOTTE-BRENNAN: I think from, you know, the asset manager's point of view, it gets back to something that you said. That you know, just implementing two options -- two or more options without knowing for certain or as certain as you can be that it would work under the bankruptcy code would not benefit us.

And the reason why I say that is, going back to what Ray was talking about, that you have certain clients who are going to say you need to take the safest option. And if we take that safest option, what we think the safest option is and we're paying more for that and then it turns out it's not the safest option, they end up where the same people who chose the least-safest option and paid less are. Then, we're not in a good spot.

MS. BREGASI: And I think - sorry. I guess our concern would be that even if we get to a spot where we actually from a bankruptcy perspective, we are sure that it actually will work. So if you pay more and you choose one model, it actually -- in bankruptcy, it will turn out to be that way.

Our other concern is whether the optionality will really be offered. So, one question would be, would the DCOs really pick something other than the futures model, which they are comfortable with today? And they understand how it works and the timelines that it works under. So it's one issue.

The second issue is, what about the FCMs? And what will be the real cost of the optionality? Because if you require LSOC from day one or full physical segregation for everyone, it seems to me that the FCMs and the DCOs have an incentive to make those work in the best and most efficient manner.

If you allow optionality, is there really an incentive to make it efficient? Or will they just make the costs of the model that's harder for them and more expensive for them so expensive for the clients that, in fact, there is no optionality? And if you divide between two different FCMs and now you have less FCMs and less clearinghouses where you have the choice of LSOC or full physical segregation if that's what you want, then do you really have an option?

Because certain -- for example, interest rate swaps or another swap in the future might only be cleared at one clearinghouse. And maybe they don't offer LSOC or full physical segregation, they only offer futures model. So where is really -- do we really have an option? And how much are we really paying for it?

MR. THUM: I wanted to go back to something that Kim mentioned. Which was the obligation of the DCO to protect the solvent FCMs from the risk bleeding over from the insolvent FCM. And if you had an FCM that opted into the futures model and other FCMs that were in the LSOC model, would there have to be some sort of limit on portability in the futures model so that clients didn't leave? Because if the bulk of the clients left, then there would not be that omnibus account.

MS. TAYLOR: But actually, there was quite a lot of talk in the documents and quite a lot of talk today about the downside of the clients leaving the FCM that is deteriorating. And I was very surprised by that, because that is exactly one of the risk management benefits that the industry has, is that clients have an incentive to want to move if their FCM is deteriorating.

So you absolutely want people to be moving their accounts if the FCM is deteriorating. And that is something that when they go -- if they take their collateral, they're taking their positions, too. And monitoring the exposure that we're facing from each FCM is something that we're doing on an ongoing basis. So, it adapts very quickly to changes in the exposure profile that the FCM faces.

But that's one of the concerns that I have about a model. And we will provide a model that provides the kind of safety and soundness that is desired by the customers and allowed by the regs. And we can make it safe, from a bankruptcy point of view. So we're open to providing the type of protection that you folks feel that you need.

But I think that there's a very important thing that's being missed here as I sat here and listened to all of you talk about the fact that if we had all these, you know, multiple FCMs spawning off to support different options. And the capital is going to get fragmented, and those are going to be less-worthy counterparties just by definition because the firms are going to devote X amount of capital to this cleared business. And if they have to divide it between three FCMs, they'll divide it. Right?

So, there's going to be a weakening, then, of the counterparties that you face. And nobody seemed concerned about that. And that's one of the concerns that I have about moving from a model that provides an incentive for the clients to care about the credit worthiness of the clearing members. I really think that is a part of the bedrock that has made the futures industry very safe over a very long period of time.

Yes, there is an omnibus customer protection model. Yes, theoretically you are all exposed every day to fellow customer risk. But there are so many protections in the system to prevent that from ever becoming a reality that it has a very good track record of being very successful over a long period of time through extreme crisis situations. In fact, it has been so successful that the government decided it needed to be the model that was applied to other markets where the safety mechanisms were not as successful. And now, we're in a place where we're going to be adding in a bunch of new business and a bunch of new exposure to the cleared model and taking out the bedrock safety and soundness mechanisms that have underpinned it.

So, the whole aspect of moving all the new products into clearing while at the same time gutting the protection mechanisms that are in place and replacing them with others that we presume will work is something that I think we need to really consider very carefully. And listening to you all talk about not caring about the -- kind of the deterioration and quality of your counterparties, this is a little bit of a concern for me.

MS. VEDBRAT: Can this now -- there's no known trigger that tells us that we have a deteriorating FCM or that we're exposed to an increase in fellow customer risk. In the government model, you know, other than being aware of your counterparty from, you know, your normal risk practices, there's no -- within the model itself, there's no trigger that would allow us to know that there is a fellow customer risk that might have increased.

MR. COX: I'd also like to challenge --

MS. TAYLOR: But your fellow customer risk really only applies when your clearing members is also weak, right?

MR. VEDBRAT: I know, I know.

MS. TAYLOR: So, you definitely can see if your clearing member is weakening. And you can definitely trigger -- you can trigger yourself to have a counterparty discussion and decide if that is still the right counterparty for you and ask your clearing member some questions about, you know, their practices and their risk management.

I realize it's not perfect.

MS. VEDBRAT: Yeah, no. I think if --

MS. TAYLOR: And obviously, you have said as a group that it is not the kind of protection that you want. And so, the industry will find another way to provide you with the protection that you want.

I guess I'm just putting it out there that I would encourage you to be thoughtful and careful about what you ask for. Because what you have had has theoretical risks. But it has absolutely performed. It's the only thing that did perform in the credit crisis. To such an extent that it has become the mechanism that everybody wanted to use to protect the world from future crises. And now we're in the process of changing it in ways that might have unintended consequences, because we're doing it very quickly.

MS. VEDBRAT: I think, Kim, but there's also this piece that, you know, the OTC market is very different from the futures market. And we do need to take that into account as we are looking at the futures model for OTC.

MS. TAYLOR: And it will be -- and it is very different. And it will remain different for a while. But I think over time, it will become less different.

MS. VEDBRAT: But if you were just to take size and tenor of the OTC market versus futures. That in itself would say that we do need to look at the model and see if we're comfortable with the risk as it stands today in futures.

I think most of us here have been talking on behalf of the swap market moving into this model, and have not really said, you know, much on the futures model itself for futures.

MR. WASSERMAN: Okay, and let's let --

MR. COX: Yeah, I just wanted to make a couple of comments. First is, this issue of fragmenting capital. If you have one FCM with a billion dollars of capital, and you now split it into two with half a billion in each and half the customers go in one, half the customers go with the other, I don't see why those two new entities are any less creditworthy than the original FCM was.

They may be, but just because they're smaller that doesn't actually mean they're more likely to default.

MS. TAYLOR: I think the excess capital will also get fragmented. I think is really --

MR. COX: But it's still the total amount of capital in the system --

MR. FRANKEL: It's the same total, but you will have pools from each side that before would have offset to some degree. And so the reserve capital you need to support those pools in each, in sum total, would need to be bigger. Because there's no offset in-between the two.

MR. COX: But I guess I'm still not following. If you've got a more diversified group of counterparties, then actually it would sort of be a less risky thing in aggregate. I mean, the pools they're offsetting would still offset, right?

MR. KAHN: In the example of 50-50, it probably does work. If you're an example of one side is 90 percent and the other is 10 percent, I think you have a different dynamic, then.

MS. TAYLOR: Or, one side gets all the longs, one side gets all the shorts.

MR. FRANKEL: Yeah, but in general it's not quite so black and white. But there is always some savings from putting it in the same pool, which will be lost. And so there will be capital --

MR. COX: Doesn't that -- that's the whole part of the clearinghouse, right? The clearinghouse is what pools the risk.

MR. WASSERMAN: Yeah, but there's another issue there --

MR. FRANKEL: No, but you need capital reserves to guarantee the --

MR. COX: Right, but you still have the same capital reserves that you -- I mean, I don't know. Maybe --

MR. WASSERMAN: It's a separate legal entity issue. Because when you split it up --

MR. MAGUIRE: It's legal entity. Separate legal entities only have access to one or the other. The net total is the same, unless it's guaranteed by the same parent group.

MR. COX: Right. But if each legal entity has got an unbalanced portfolio compared to what the original one had, soon you're going to charge them more margin.

MR. MAGUIRE: That's correct.

MR. DIPLAS: Well actually, there is a difference also depending on what you do in the guarantee fund calculation. We're talking only in the margin here, there's not really split in the guarantee fund calculation because it's going to be done at the clearing member level.

MR. COX: Right.

MR. DIPLAS: You're going to get the offsets that you don't get when you do the initial margin at the cost level.

MR. MAGUIRE: There would be a minimum contribution to a guarantee. I think one of the main things is minimum contributions are guarantee funds. So if today you put --

MR. COX: Absolutely --

MR. MAGUIRE: -- 2 per -- if you put 10 for 1 clearing member, you'd have 20. That's where it really has impact.

MR. COX: Because then you have true fixed contributions. Then as you split off, more

-- you know, it's going to become less efficient for the ability of the parent entity --

MR. DIPLAS: I think the minimum is kind of peanuts, practically speaking. I mean, whether it's 10 or 20 or 40 -- each one, for most entities. The -- most of the active, at least, FCMs will be way above the minimum guarantee fund contributions.

The officers, I think, within about 40 are probably much more substantive at the guarantee fund level than anywhere else. But anyway, we're digressing a little bit here.

MR. WASSERMAN: Yeah, and let me let some folks at this end of the table --

MR. WINTER: There's one other issue, though, related to if you split the two FCMs. And it's also, what's the other activity the FCM is performing? Because it's not just clearing customer business, it's also clearing proprietary or affiliate business. And quite frankly, most FCMs that have gone bust have gone bust not because of the customer business, because of the proprietary activities. So you can't ignore that.

And so where does that business then fit in? Which entity does it go into? And does it therefore increase the risk to the clients in one entity over the other? So you can't separate the two in that regard as well.

MR. WASSERMAN: I would note that under any of these models, the clients are fully protected against proprietary losses.

MR. WINTER: That -- I'm not suggesting that, the commingling losses. But there's a higher probability that there will be a failure in one entity over the other, potentially. Just because of the proprietary activity.

MR. WASSERMAN: And then there is the exposure to the loss from liquidation.

MR. WINTER: And the other clients that could be in deficiency at that time.

But the other thing I'd like to throw out there, though, is that when we talk about optionality, again the issue is when you look at the buy side today, they have the ability to control how they manage their risk. They do that today in the OTC market. They can use triparty, for example, for getting bilateral and all the rest of that stuff. But they can do triparty. Why couldn't you allow triparty in the clearing mechanism? That would give them the same protection, recognizing that they'd have a triparty somewhere else.

The FCM has to substitute its own cash or collateral to meet the margin. And that's no different than what they do every single day today first thing in the morning, because they first have to pay up the clearinghouse in the morning and then during the day they're collecting that money from their clients.

MS. TAYLOR: I think you have stumbled into optional physical segregation. Which apparently doesn't work without an account class. Which I think we could create an account class for it, but --

MR. WINTER: That's exactly the point. I think you create an account class, you allow for triparty, you resolve the problem, and it's not overly burdensome.

MS. BREGASI: But if triparty works, why are we making it optional? Why aren't we just making that the model?

MR. WASSERMAN: And the difficulty is -- I mean, right now -- first off, we're talking about triparty I think in the current world is that the collateral is not -- so the collateral wouldn't be going up to the clearinghouse. The collateral would be sitting at a depository. And I'm not sure, Kim, if that's something you're going to be comfortable with, or?

MS. TAYLOR: Well, I mean, the way that the gentleman described it, the clearing members fund this now when they have triparty arrangements where they are allowed for other things.

So, I think what it really boils down to is, we have to figure out what problem we're trying to solve, and then come up with the best conclusion for how to solve it. Because if being able to use your triparty accounts -- which I think is what your issue is. Because you have them in the OTC market, right? And you feel that you're protected, and you probably are protected from the default of your prime broker counterparty because you have your collateral in a triparty account.

And the problem with the moving to a cleared environment is that the basic existing CFTC customer protection mechanisms pulls that. You could still have a triparty account, the firms could still finance it, they could still put the margin up with the clearinghouses. But when it all shakes out, that would be subject to a pro rata distribution, along with everything else.

So if we made those triparty accounts, that's exactly what I mean when I say full physical segregation with an option. Because not everybody wants -- not everybody now has triparty accounts in the OTC arena, right? Only some of you feel that it's important enough to be worth the costs or burdens or whatever it is -- the work to set it up. And then, those of you who do that work to set it up reap the benefits. And people who don't, don't reap the benefits.

That is -- other than sticking with the existing model, which has theoretical risks that really are very low probability of happening, I think that's the best option.

MR. THUM: I just wanted to respond to one --

MR. WASSERMAN: Just to clarify a question, though? Under the third party model that you're thinking of, would the initial margin be held at the third party? At the clearinghouse? Or, both?

MS. TAYLOR: I think it depends on what problem we're trying to solve. Sometimes I think the problem we're trying to solve is that you don't want your -- you'd rather have your money with the clearinghouse than with the FCM. But I think that that probably goes away if you've got triparty, because they don't really have access to the money, either. Right?

So I think it could be done either way.

It depends on what problem we're trying to solve.

MR. WASSERMAN: So you're saying you would accept a model where the collateral of the customer is not held at the clearinghouse, but only at a third party depository?

MS. TAYLOR: If the margin at the clearinghouse was funded by the clearing member.

MR. WASSERMAN: So, both. So in other words, the model you're talking about is one where --

MS. TAYLOR: It's a collateral upgrade model, basically --

MR. WASSERMAN: -- the client has money at the third party and then you'd have double seg with the firm, posting money at the clearinghouse.

MS. TAYLOR: But I would also accept a model where the third party account attached where -- attached to -- I'd accept a full segregation model that could be made to work where the attachment of the third party account was actually between the third party and the clearinghouse, if that solved the problem. But it comes down to, we have to figure out what problem we're trying to solve and then find the very best way to solve it that works for the clients and the FCMs and the DCOs. Because it has to, ultimately, work for all three legs in order for it to work, right?

MR. THUM: I think the problem we're trying to solve is very basic. And we have it now in the bilateral world. And that's if we're not defaulting, we want to get our margin back. So, we accept in the LSOC model we may be susceptible to investment risk, but we're not susceptible to fellow customer risk.

Also, I think it is important to point out that if there is the optional approach and there are two FCMs and there's got to be two pots of capital, that would be an issue for us as we choose our FCMs. And indeed, in interviewing FCMs one of the main components has been what is the capital level? Is it set at a minimum level required by the DCO? Is there some cushion there that we could then monitor? If the cushion goes away, then we decide to move it to another FCM well before there's a problem with the FCM.

So indeed, I don't know that anyone here suggested that that's not a critical issue. Certainly for Vanguard it's a very critical issue. But the problem to be solved is getting the margin back. We don't think we will ever default. And in the Lehman situation, the bilateral world, we were well protected. Certainly we were protected with our futures, given the way the futures model is set up and the risk parameters of the future product.

In the derivatives model, though, not only do we hold all the collateral of the custodian we also, in evaluating our derivatives dealers, in the event the volatility of the position is great, we go out and buy CDS protection on the dealer. So, there's many levels of protection that we can build in in the bilateral OTC world. And we're looking to get not significantly worse protection in the new cleared derivative world.

MR. WASSERMAN: Okay, let me have

another chance --

MR. FOLEY: I just -- I mean, I don't pretend to understand the finances of all this. But I do know, I mean, that we have third party accounts authorized for several years -- many years. And my understanding is, the firms who offer that even for futures found it to be highly expensive because they had to use their own funds to finance the margin at the FCM. There are capital implications for doing that.

If we're -- if that were to be offered in with swaps, where my understanding is that the margin will be higher, the charges on the firms will be that much higher. And I think it's going to become exceptionally difficult for FCMs to offer this.

One of the goals of the Dodd-Frank Act was to increase the firms, the clearinghouses, dealers who were going to be involved in the swaps market. And it seems that everything that the rules try to fix only serve to narrow who the FCMs are who are going to be able to afford to do this

-- who the clearinghouses are who are going to be able to afford to do this. And so I'm just concerned.

I mean, I think it's wonderful to offer this. And as Kim said, everyone wants to give their customers what the customers want. But we need to find a way to get it done in an economical way that -- and a way, obviously, that fits within what the law is at the present time. If we need to change the law, then let's all get together and change the law.

MR. MACFARLANE: Tudor would happily pay the incremental costs, both in terms of collateral and operational costs. And we've invited our FCMs to come up with a model and show us the cost.

We already pay a higher cost in our execution of OTC transactions, through the use of the triparty mechanisms. We've spent money to put triparty mechanisms into place. We've paid custodial fees to the custody bank that holds the triparty collateral.

The cost of not doing it is actually

greater, in our opinion, because if we did not have those mechanisms in place and we had another event as we did in 2008, the uncertainty that's created by not knowing who we're sharing risk in the omnibus pool would cause us to pull our capital back from the market. And so, as many leveraged players did, they delivered their positions in September of 2008 because they weren't sure about their prime brokerage risk.

Similarly, that could happen in the OTC market if we were unsure about who might be in the pool with us and whether or not they might default. There's -- that's not hedge-able. And the only way to reduce our risk is to de- lever. So we'd be pulling capital back from the market at a time when the market would most need that capital.

So, again, it comes back to the point that I think Dan made at the beginning. We've got to be careful that we find a balance between operational, efficiency, collateral efficiency, and what's right systemically to make sure we don't build something that will be weaker if we -- not if, when we have another crisis.

MR. FOLEY: I'm not challenging that. My point is that my understanding is, these accounts are highly expensive. And I don't -- so I think it's something that would have to be looked at very carefully, taking into account.

MR. MACFARLANE: Well, getting back to Kim's question, what does the client want? Speaking as a client, we want better protection and we're willing to pay for it. So -- and I think if -- getting back to Bob's question. You know, if you give -- if you unnecessarily restrict the market's options, you may push them into a model that does not suit their risk profile. If you give them options, they can pick something that suits their risk profile and they can make the decision as to whether or not they want to go with an omnibus model and post less collateral but take the risk on the back end. It's a pay me now or pay me later, I think, equation.

And others will choose the other model,

which would give them more certainty about whether or not they get their collateral back.

MR. WASSERMAN: Nevis.

MS. BREGASI: I just wanted to make two points. I don't think -- I still didn't really understand whether the DCOs are happy with leaving the collateral at the triparty. So instead of having the FCM separately pay the DCOs while the collateral of the customer that's supposed to do the FCMs stays at the triparty. Because I think that's where Kevin's point came in about it being very expensive for the FCMs.

MS. TAYLOR: And from our point of view, we would want to work through the nuts and bolts. But I'm confident that there is a way that we would be able to be comfortable with that.

MS. BREGASI: So I think --

MS. TAYLOR: So --

MS. BREGASI: Just keeping it there, if that's the case then I think Kevin's points about the FCM -- this being very expensive for FCMs would not stand. So that's one point I wanted to make.

And then the second thing on optionality. While I totally agree that it's better to have optionality than just to stick with the futures world, going back to your point about in today's world not every customer wants triparty and a lot of them chose not to have triparty, I also want to say that we want triparty and cannot get it from brokers. So in fact, there is no optionality today. They will only do it if it's legally required. So for our mutual funds, they're happy to do a triparty. For our other accounts, they are not legally required to keep their collateral at a triparty, at the custodian.

The brokers are not coming back and saying, we'll just charge you more. They're saying, we're just not doing it. I know that they are doing it for other asset managers that are bigger than us -- and we're not small. We have $240 billion under management. But right now the answer for us is, no.

So, my other concern with optionality --

like I said before is, whether it's a real option.

MR. NICHOLAS: Is that futures? Or is that --

MR. COCCO: Sorry. Bob, this is Alessandro speaking for the dealer -- for at least my institution. We have trilateral agreements on the OTC side for some clients. And it is something that we work on.

I think that if you take a lot of the collateral for the whole market and place it into third party custodians, I think you would be appropriate to conduct an analysis of, is it really safe once it's there? And who bears the risk of a failure by the custodian?

I think those are questions that would be -- it would be very prudent to find very clear answers to those questions. I'm not saying it doesn't work or it shouldn't be offered. I'm just saying we should make sure it works, if that's the route that we go towards. Because from a systemic point of view, you would want to make sure that you have adequate protections for FCMs for clients, of course. For the clearinghouse, and also for a third party custodian.

MR. NICHOLAS: Just to -- sorry. To throw in my thoughts here. I certainly understand the concern of the customers to limit risk. Obviously that's critical.

But I wonder -- and I guess this is more of a question. Isn't another path towards limiting risk getting perhaps more information about the FCM? What are the -- you know, information that's not currently being disclosed, leverage issues, concentration issues, proprietary trading issues. Doesn't that really get to your concern more?

Because even in a complete legal segregation model, given bankruptcy limitations I'm not sure that in all cases you'd be getting everything back. I'm not a bankruptcy expert, but I'm not sure that that's the case. Whereas if you're looking deep into the FCM, you're going to see your real risk.

MR. WASSERMAN: And I think we're going

to address those questions this afternoon in detail. Because I think there are some interesting issues in terms of, you know, the motivations of the buy side. And we've sort of alluded to that. And there's also been some allusions to, well, how much information can practically they get and can practically you give them.

But, I am -- it's pointed out that the time -- we've gone fairly over. And I really do want to make sure that everyone does get a chance to have a good, healthy lunch. And so -- it's only an hour and five minutes you have. There's a number of places around here. And I very much look forward to having folks back here promptly at 1:30 to begin.

(Recess)

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MR. RADHAKRISHNAN: Please take your seats for the third panel.

MR. WASSERMAN: So, housekeeping detail. Please everyone remember to turn your mike on when you speak and then turn it off with the red button. Then we have two folks who are new to this panel and I will let them introduce themselves.

MR. PRAGER: Thank you Bob. Ritchie Prager, BlackRock.

MR. HARSHAW: Jim Harshaw, GM Pension.

MR. WASSERMAN: We're now going to talk about the advantages and disadvantages of the different models, and most importantly, the advantages and disadvantages of the models compared to each other. One of the things that was alluded to earlier and I'd like to raise it here now is what are the differences if any between swaps and that industry and both cleared and uncleared and the futures markets that are relevant to this discussion?

MR. PRAGER: I think we heard some of it

in the prior panel and I think it's a great question to start with to frame some broad differences. When we look at the OTC market and the swap market and look at some of the statistics published by ISDA, my understanding is there is some $600 trillion notional outstanding. We have today I think in the cleared space some $200 trillion of which is cleared primarily on LCH in a dealer- to-dealer environment. So that's one metric. I think if you look at another metric and you look at tenor, I think most dealer books' outstanding average life would probably be somewhere between 3 to 4 years. If you look at LCH, my understanding there is that the average life of their cleared population is some 8 years of tenor. So if you start thinking about the variation margin in the context of 8-year average life, that's something to consider. Then if you look at CME and some of your figures, and I'm sure they'll help me if I get their figures very, very wrong, but I think in CME's interest rate complex, just thinking of Eurodollars, T notes, SET funds, there is some current open interest of some $15 trillion or so. And if you take Fed funds out of that it's about a $11 trillion size market. So a very different size that we're talking about.

Then if you look at the tenor, most futures are fairly short dated in maturity. Think of rolling in Eurodollar futures with huge volumes, most of the volume is in the front contracts and they mature every 3 months, so the variation margin over the life of 3 months is going to be very different over the variation margin of something that's 8 years. So I think when we, again it's a great benchmarking question to start with because when we start talking about these different models and we defer to something, we say we defer to the futures model, in a lot of these conversations these are apples to oranges when we start talking about risk. That would be my cut at the broad differences.

MS. TAYLOR: Can I ask a question though, Ritchie? You're making it sound as if there's a difference in the way the risk posed by the variation margin if something exists for a long period of time or if it exists for a shorter period of time and with the variation margin being settled every day, I'm not sure I understand the distinction.

MR. PRAGER: Well I'm just looking over the life. I think that's a fair point, Kim. I think first of all these sheer volumes, we're talking very, very different sized markets. A lot of these futures that we're talking about in the futures market are very short dated contracts anyway so if you look at the daily variation margin of something that has 3 months of duration and a very small BVP versus an average life contract of 8 years, just the daily variation margin alone and the sheer size and the longer duration with the higher BVP are much larger numbers.

MR. DIPLAS: Ritchie, I agree with your comments already but I would add to that also the difference in terms of how the products trade in the sense that a lot of swaps reside in a book for a long time after the initial trade so that the unwind aspect of the book is going to be different versus a shorter dated 3 month future basically, which is eminently observable so that it requires a longer unwind horizon and it has to be handled with more care I guess.

MR. KAHN: Also the operational needs of margining and doing the computational calculation every day is different on the OTC products. They have longer dated cash flows and they have coupon resets and things like that. So in doing the portfolio every night, which both the FCM and the CCP need to do, it is a more computationally complex instrument.

MR. FRANKEL: Also more model based, valuation is more model based. While we build an interest rate curve, all the off the runs or anything that's not traded that day is discounted and so there's a model valuation that's separate from a widget price that trades in the central order book. There is no central order book for the swaps.

MR. RADHAKRISHNAN: It seems that the comments you're making go toward differences in how they could be cleared.

MR. FRANKEL: Yep, and also the variation margin is collateral, which is a rather substantial difference from the futures clearing model where variation margin is daily settlement.

MR. RADHAKRISHNAN: So you're saying the VM is collateral. What is IM in an OTC trade?

MR. FRANKEL: Also collateral, but the VM collateralizes current exposure and IM collateralizes potential future exposure is the way we think about it.

MR. HARSHAW: I think one of the things that's important to understand is that in the OTC area for most of the people on this side of the panel, the buy side, they don't post what you call in the futures area initial margin, but in the swap area it's called independent amount so that out of the box when you go to the cleared side, it's an economic negative. Second, the models that exist today, the futures model and the swaps model, over 90 percent of global derivatives are done in the OTC swaps market as compared to the exchanges, and people have chosen that for a reason. There is a lot more flexibility in the OTC area to establish the types of protections that you want to have with your counterparty, how much you want to be exposed to the risk, how little you want to be exposed to the risk. When it comes to the margin that you post in the futures area, you really don't have much choice. In the OTC area you can negotiate that, and in addition you can actually control it, and that has important portfolio management consequences. If I'm holding a bond and I've got a triparty, that bond is still mine. It's pledged for the benefit of the secured party, but it's still in my portfolio and I'm getting the income on that bond and when you look at my assets list it's going to have that bond.

In a futures area, I give up a bond to the FCM. Your treasury could get converted to a grease fund the next day. I don't the treasury in my portfolio anymore. So there are significant differences between the futures and the swaps market and today the buy side ops for the swaps market model.

MR. WASSERMAN: Let me try and focus folks a little bit though on the distinctions to the extent there are any between swaps as they might be cleared and futures. One of the points that folks have raised is wait a minute, we've got a futures model. It works. It's worked for a very, very long time. So we should then bring swaps into this model that has proven itself. I guess the question is are there in fact any differences that would challenge that or in fact is a cleared swap really the same as a cleared future and maybe that argument has weight?

MR. HARSHAW: I think one of the things that we need to pop pretty quickly is the 100 years example. In 1987 when the market crashed the CME as I understand from people who served on the Risk Committee during that time went to get margin from the FCMs and many of them couldn't post it because they couldn't get it from their banks, and when margin is called it's called on a T plus 1 basis from the customer and on the CMEs we understand that they could get called that day. We understand that there was pressure by the government to force the banks to lend to the FCMs. Had they not gotten the capital, we may not be bragging about CCPs today. In fact, one of the CCPs in Hong Kong went under. So we're talking about a structure that hasn't been tested. It's a bicycle compared to the OTC car and it's carried the weight of that person, but now you're taking tons of bodies and trying to put them on the bicycle and it can't bear it. What we're saying is that the risk assessments of the CCP need to be rethought in light of the volume.

MR. MAGUIRE: May I come back on that because it has been tested -- cleared interest rate swaps. Ours traded in the OTC market and no change to the way they're executed which negates statistics just to correct them a little bit. We have over 50 percent of the open notional going through swap clear today and when Lehman Brothers defaulted that was a $9 trillion portfolio of interest rate swaps, idiosyncratic, no trade the same so therefore no profile of risk on each trade, the same, so nonstandard. The 66,000 trades were at maximum maturity of 30 years. They were in five different currencies and we closed all that risk out using in the region of 100 to 150 hedge trades in the market, big trades, macro hedges and then auctioned the portfolio and gave that back to the market. So that was all done well within the margin that we had at Lehman so that nobody was impacted in a mutualized way. Obviously this is very much dealer to dealer, centric back then and we're expanding that model out now to dealer to client. But to say these infrastructures haven't been tested is not 100 percent true. I know Kim mentioned in one of the earlier sessions that one of the reasons we're moving into this model is because of the success of the futures model. I'd like to think as well that's maybe something to do with the successive closing out of the large OTC derivative portfolio at Lehman as well.

So if you take a slice of our portfolio which is cleared swaps, we'd have 910,000 trades. When we did a slice through of about 850,000 trades that we had, more than 95 percent of those trades using eight fields to match were difference so that every single trade is pretty much different than you clear today. I think that's a fundamental difference, to answer your question, between swaps and futures. They're not standard, they are different and they are idiosyncratic. So I think we have to be very cognizant that you can take a swap product or an OTC product and clear it, but to Kim's point, the risk profile on these, the maturity profile, the way you hedge these, is very different from futures. But I think I'm sure everybody will agree on the DCO that the risk principles we apply should be the same, it's just maybe the metrics and the models should be slightly different.

MS. TAYLOR: I would agree with the

statements about the way that the model has worked and the way that it's been tested. The fact that the Fed flooded the market with liquidity in the crash of 1987 is going to have been a fact whether or not there were futures or not and all of the settlements were met at the CME. There was not a failure by any participant at that time. So that was a test. I think the credit crisis period was a test certainly on the Lehman side in London where there actually was a default. But I would suggest even on the Lehman side in the U.S. Because of the difference in the bankruptcy structure, the registered entity didn't actually default but it did operate in a state where it had an impaired parent and I think that the mechanisms that were in place operated very well to be able to allow customers to manage to a very good outcome in a very stressful time period.

MR. WHITE: I'd like to repeat the question but maybe in a little bit more focused way of taking some of the observations that people have made about differences with swaps and again taking as a given that we're talking about the subset of swaps that are going to be cleared in the future, then focus especially on how if at all these differences would affect fellow customer risk. Even if there's a greater volume on a transaction-by-transaction basis is the fellow customer risk and managing it either from the DCO or customer kind of way going to be the same or do some of the differences that Dan for example has talked about affect this.

MR. HARSHAW: I think one of the things on the fellow customer risk is it's just not something we have to deal with today so that again you have the untested aspect to it. On the sell side, has a lot more experience than the clearing side, there's been very little cleared by buy side and so the experience that maybe other people have had and have tested on hasn't really been so on the buy side. We're really not set up to measure the credit aspects of any other customer let alone all the customers of an FCM. Frankly, we don't feel we have enough tools to measure the risk of our FCM. We don't feel the DCOs have enough tools to measure the risk of the FCM. We think capital is a specious test because you could be levered out the wazoo and have a lot of capital and we've certainly seen that to be the case. We think leverage is hugely important. AIG was highly rated but highly levered and none of us knew that. So I think for us the fellow customer risk just underscores the fact that the buy side just doesn't have the tools or the information to evaluate it.

MR. PRAGER: If I can add on to that, I think this is a key point and so if you look at both fellow customers and FCM. We talk about Lehman and the very successful experiences both the CME had with futures and LCH had in cleared swaps, not every situation we're going to have CNBC talking to us for weeks in advance basically saying move your exposure. That was a unique situation where there was a neon sign flashing 24 hours a day saying you may want to think of moving your exposure so I don't think we can count on that unless the DCOs themselves are going to establish that neon sign and somehow rate the FCMs and somehow put out a yellow warning or red warning or whatever because we don't know. We can make our own initial assessment on the health of the FCM and we do. We look at capital and we look at other metrics, but it's largely judgmental with not a lot of objective measures in terms of their ability to select clients, their ability to comply with DCO rules. We don't know if you publish the ratings. It would be great if there were some sort of rating system. I go into a deli in New York and I see a little score there whether I should buy a sandwich our not.

Then on fellow customer risk, no idea. Clueless. We are then back to looking at the FCM and the DCO to provide guidance so that we have no idea if there is an Amaranth in there, if there are other types of clients, and we have no idea. They may be in every FCM. This is an area of great concern where I think that's a risk that we do not take today in the bilateral swap world. We do not have to worry about it. We can insulate ourselves some from it full stop. So I do think this is a very key component and we wrote that in our comment letter that we'd like to see something coming from the DCOs on how they monitor the FCMs and what guidance they can provide clients with.

MR. EDMONDS: I was going to say, Ritchie, I think it's a little bit bigger than any one DCO. There is common membership across all three of us and some entities and other entities have different levels of that. At some point in time that may need to be a regulator function providing that. With your deli analogy, it's not the individual block association that's putting out that sign that says this deli is good, it's the Health Department of the City of New York. We would like to see that too especially as we've evaluating membership and offering new products and soliciting the right group of people to provide that service in the right level of distribution out to customers like yourselves. We also need that type of help and that's going to require some effort from this agency and other agencies and if we think about the holistic view of that when some of the clearing members are registered banks of there's the likelihood that some of them will be or have some affiliate structure with that and the rules around that, we also need to know what that means on the other side and what those regulators are thinking and there is no good place to go to. So even though I could give you an A rating on FCM A, they may not have A ratings at the other two places and vice versa. There is no single place to put that and it's a risk I think we all face in the industry, not just your side of the fence.

MR. MAGUIRE: I agree with that. You have fellow customers, we have fellow CCP risk I guess. We need to know what the leverage is, the capital is, the risk, about their leveraging and how it's being used, what the liquidity aspect would be on the capital that they've got. We can't see that. We can see what we can see, but we can't see across the piece. So it's a similar issue that the buy side is raising. But in terms of differences between futures and swaps with reference to the account structure, there's a blend of things. Obviously the swap products and the OTC products are longer dated. We could argue all day, but one would argue that longer dated probably has slightly more volatility in price. We could argue about that, but equally one thing we wouldn't argue about is liquidity and the further out the time structure you go, the further out the maturity profile you do, the less deep the market is and the less liquid the market is.

So what does all that mean? It means that in the worst case scenario where we have a default, it's going to be hard to close out that risk. If it's going to be hard to close out that risk, the last thing we want to do is have to close out more than the defaulting entity. In terms of collateral segregation, an LSOC or a full seg model for that matter, a segregated model. We have pretty good confidence because we can see the client's I.D., we can see through to the end client and we can apportion the collateral in that model. We can safely lift those people and move them to a safe clearing member at that point so as a DCO we don't feel necessarily that we're going to have to close out additional risk for somebody who has not defaulted, they just can't port and the reason they can't port necessarily is because in today's structure in the omni account we're not going to let people port unless we are confident that we're not going to have to use that client mutualization there. Whereas under an LSOC model we can say you can go as fast as you can go rather than as fast as the slowest person.

MR. WASSERMAN: To clarify, what I'm trying to understand, Dan, is what you're saying there's a difference in liquidity generally between cleared swaps and cleared futures?

MR. MAGUIRE: I'm saying there's a liquidity difference and it's harder to close out longer dated risk on swaps than it would be on a standard futures contract where you trade in and out.

MR. FRANKEL: It's that the risk is so much bigger and there's no central order book to put it, but the risk is so much bigger.

MR. DIPLAS: I think the biggest difference between the futures and the swaps, first of all, traditionally futures trade in a silo environment. You will see one risk being in one location. Here we're most likely going to have the same instrument traded at at least two CCPs. It's going to make it more difficult for them to actually see for the same shock what is going to be the behavior of the client and how much is a certain client affected. They know that they have exposure to a billion of an index in CME but there might be another billion in ICE. They don't know what the impact is going to be. I think when it comes to assessing the health of the clearing members, the FCMs, I agree with Chris that they don't have the tools to actually do that themselves. At some point I think we're going to need the regulators to be able to try to conduct some kind of stress test for the existing FCMs to access the health of those FCMs for general shocks in the market.

MS. TAYLOR: I think there's a difference, I would draw a distinction I think between the ability to manage risk at the CCP level or at the regulator level and the ability or efficacy of putting out a rating. I think we all found that the rating services sure put out ratings, but they weren't necessarily as helpful as they might have been relied upon to be. But as far as risk management, we do our risk management in the listed business and we're set up to do it in the over-the-counter business at the individual customer level. In the futures world you can't see every customer. You can only see the ones that have 25 contracts or more so you can only see the ones that are even by anybody's definition marginally material. If you have any kind of a presence in the market, we can see you. We can evaluate the concentration risk that the clearing members have among their customer base and the CFTC as the central mechanism sees that across all of the markets and I presume will see that across all the cleared and probably the uncleared swaps because of the SDR and the reporting functions that will be in place. So I think there will be an ability for there to be risk management that is performed that includes each CCP doing it from their own viewpoint and then the regulator being in a position to do risk management at the overall.

MR. DIPLAS: Who is the we you're talking about? You're not going to be able to see the uncleared transactions that someone else will have. Only the regulator will have access to that information.

MS. TAYLOR: Right. We each can see our own piece, the DCOs and the regulator can see the whole picture.

MR. WASSERMAN: Before we move on to risk management and we will, I wanted to wrap up one point I'm trying to understand here. What I'm hearing is that there is greater risk because of perhaps either longer structure, lesser liquidity on the swaps end than the futures end. The question is, what would the impact of those distinctions be for fellow customers?

MS. TAYLOR: I think one of the things is you're hearing that there is more risk but you didn't also mention that there is different risk management that attaches to some of those risks. Those products are margined differently from the way that the simpler structures are margined and the default management practices that each of us has in place to facilitate the liquidation of the less liquid, less visibly liquid product sets are very different.

MR. WASSERMAN: That default management would be --

MS. TAYLOR: It is different risk and it's managed differently as well.

MR. HARSHAW: Bob, I think one of the key points here to understand is that when you're talking about collateral, we have transparency right now so in a triparty arrangement there's a third party record keeper independent of the FCM who gives transparency on the collateral that's been posted by the FCM or the collateral posted by us, I mean our swap dealer, or the collateral posted by us for the benefit of the swap dealer. In the DCO world, what we understand, and I'm glad to stand corrected, is that although the DCOs and they vary among them in terms of what they can see at the customer level, although they can see margin exposure, they don't see collateral. So they don't get to see what I posted to the FCM. They get to see my margin exposure for my contracts, but the DCOs don't have transparency into the collateral. So there is a key protection that we've got in the OTC area that doesn't really exist in the CCP area and that is the transparency on the collateral.

MR. WASSERMAN: Let's focus on that.

MS. TAYLOR: And on a day-to-day basis we don't see the collateral that's in the account of a customer at an FCM, but we do have transparency into the efficacy of the practices of holding margin and holding it in segregated accounts through the financial supervision and audit functions so that there is ongoing monitoring of that but it isn't a day-by-day view into the balance of the accounts at any point.

MR. HARSHAW: It's a periodic versus a daily reporting that we can get from a third-party bank.

MR. WASSERMAN: Just to be clear, as I'm understanding what you're saying, Kim, you of course know what they've posted with you.

MS. TAYLOR: I know what the FCM has posted to me and if we live in the LSOC world I won't know anything different in an LSOC world than what I know now because right now I'm margining each account individually, the FCM has enough margin up so if you allocate it across all the requirements, everybody's got enough margin up and that's exactly the same thing that I will know in the LSOC model. I won't know that it's actually James's collateral though.

MR. WASSERMAN: No, you don't know whose it is. In other words, you know what you have.

Secondly, as I'm understanding it and I understood this way before and this is what I'm hearing you say now as well, you supervise your members. You don't know every day what they've collected from customers, but on a periodic basis you look and you see what they've collected and you evaluate then if they are undertaking what is from your perspective appropriate risk management.

MS. TAYLOR: That is correct.

MR. MAGUIRE: Bob, this distinction between full seg and LSOC, on the full seg, if James does a trade or a bunch of trades via an FCM and the margin on those trades is 100, the DCO will not register or clear those trades unless they've got 100 from the FCM so we will always see that we have 100 against those trades and if William next to him has done 100, we'll see 100 as well and we'll have 200 in the account so that we'll always see the collateral value. The distinction here is that we won't see that James gave the FCM some T bills and William gave the FCM corporate bonds and did some transformation and passed them through, but we will always see the collateral value relative to their risk. We will always have that reconciled in the clearinghouse, certainly in the LCH model.

MS. TAYLOR: That would be true in any model that we would have collateral.

MR. EDMONDS: Even in the case that we have today at ICE Trust, we take gross margin on behalf of clients' trades and if a clearing member today charges additional margin or we'll call it excess, so if the clearinghouse is calling Dan's example $100 for that given position and the clearing member says we need $120 to support that position for whatever the reason and whatever risk management they've decided to put on the customer account, we're collecting all $120 in that or at least $120 is being paid. But to Dan's point, the composition of that $120 and what you may be giving to your clearing member, there is no visibility in that. All we know is that we needed $100, $120 was collected, we're taking that $120 and we're segregating that off and putting that out of harm's way.

MR. WASSERMAN: So as I understand it, on a day-to-day basis you don't have that visibility. Do you have the ability to look at your members on a periodic basis to determine the quality of the risk management that they have?

MR. EDMONDS: We certainly monitor their behavior on a daily basis and I would say that there are periodic reviews and certainly there are times where operational issues around their risk-management capabilities are discussed at appropriate levels within the governance structure in our entity.

MR. HARSHAW: My question would be did that help in the Lehman situation? Because the reality is that you can have that periodic oversight but it didn't stop anybody from allowing Lehman to continue to clear.

MR. WASSERMAN: On that score how much did you folks lose in Lehman?

MR. MAGUIRE: Zero.

MS. TAYLOR: Zero.

MR. HARSHAW: One of the things that we're talking about is what happens with my collateral and what's the risk associated with that. I think we'd all agree that this room can accommodate a certain number of people and we're all comfortable with that, but as the numbers get bigger our level of comfort goes down. As we talked about at the beginning, the volume that these platforms have had before, while significant in certain cases, has certainly not been the $600 trillion.

When I post collateral today, I get to see it and I get a walk through its transit. That transit risk doesn't get protected, it doesn't get covered in the LSOC, it doesn't get covered in the futures model, so when variation margin comes back and forth it gets passed around and there is risk in transit. One of the advantages to the triparty arrangement and as was suggested this morning perhaps adding to the DCO to that is that you don't have that transit risk. So in a bankruptcy where there are tons of players, much more than we've ever had before, on the clearing experience that people were talking about and praising that there was zero, there were a very few players on those markets because it was just the dealers. Now we're talking about adding the whole market. So albeit it's comfort. Is it complete comfort? Absolutely not. And we would say when we went through Lehman we had tens of millions of dollars of exposure to Lehman. Guess what? We got it because it was in our account with the bank and it protected us. What we're saying is if you're asking me to get out of a car with air bags, seat belts, side bags and get into a car without that, I say I should have a right to wait until it has it. So we're suggesting that the optionality model here would address collateral, these transit risks and these other risks and we should just wait until we get that taken care of.

MR. NICHOLAS: I mentioned this toward the end of this last session, I think one of the things that would make the buy side feel more comfortable is greater insight and greater disclosure into the FCMs as this gentleman at the end of the table said and it's something that we suggested in a comment letter that we wrote some time ago on this topic, greater disclosure. I speak for our firm, but I don't believe that many FCMs would have an issue with that.

MR. WASSERMAN: Let me ask about that because I assume what you're talking about is things about information on your balance sheet.

MR. NICHOLAS: Yes. What I was thinking is I'd be very interested to hear from this group what information they would find useful or what would think would be material information that they're not getting right now.

MR. WASSERMAN: Let me ask this. Would the information that you're willing to disclose also include the policies that you have for doing risk management?

MR. NICHOLAS: I would think so.

MR. WASSERMAN: Would that also include the exceptions to those policies?

MR. NICHOLAS: I don't know. I haven't

really considered that, but again I'd rather hear from this crowd.

MR. MACFARLANE: Bob, I'll take a shot at that. I think if given the choice between more transparency around our FCM and their policies, and it would have to go beyond that because we'd have to have transparency into who else is in the client pool if we're using the omnibus method. If I had the choice of that versus a full segregation model that would give the certainty around the collateral, I'd choose the latter because the former while it would give you some comfort, the world is a very dynamic place and those exposures, those financials, those counterparties can change from one day to the next. I think many of us, you've heard that there is a common theme, we'd really like to have control over our own destiny. That's what we've had in the OTC market. We've been able to choose our OTC counterparties, we've been to isolate our risk. If we choose one counterparty and not another, we know we have no exposure to that counterparty. However, in an omnibus model, we could be exposed to that counterparty in the omnibus pool so we'd lose control over our own destiny. Again, I'm sorry to come back to this, but if we're not given a choice, what we will choose to do in a market that is disrupted, we will back away. We'll pull our capital away and that will add to the diminishing liquidity in the marketplace that will already be there as a result of the crisis itself.

MR. PRAGER: If I could add, and I completely agree with John, if given the choices, I'd rather not have to make those judgmental calls based on ratings and judgments of fellow customers, and as a fiduciary we would like not to have to make those types of risks. We are hired to make investment risks and if we could standardize this by having the segregation and take that decision making away and then we can focus on our expertise, that's what we're hired to do. Maybe where we end up is forcing more disclosure with FCMs and then we are going to just have to hire ourselves more credit people that can make those assessments and we will be forcing you, John, to tell us every time you have an infraction and we want to know whatever the regulators do to sanction you, we will expect that to be disclosed and we'll want to know all those customers. That sounds to me like going down a path which is unnecessary given the options on the table and the proposed rule negates the need to do all that.

MR. WASSERMAN: To be clear, if you were to do that, would that impose any costs on you?

MR. PRAGER: Absolutely. That's why I said we'd have to hire all sorts of risk-management people, we'd have to be going out doing the same sort of diligence. Ken was talking before about soaring audit costs. We'd have to hire whole departments, go out to interview FCMs, monitor change every time there's any change in their balance sheet, look at different customer profiles. It's just a whole different nature of risk that today we don't have as you heard down here in the bilateral world. We have a limited a number of counterparties, but we don't have this notion of fellow customer. That's this unknown to us.

MR. NICHOLAS: I'm not sure I completely agree with that because even when you're dealing with a dealer, that dealer has multiple products, multiple activities, multiple customers, you don't know on the other side of your activity what it's doing necessarily.

MR. PRAGER: But if we're in a triparty it's not an issue.

MS. TAYLOR: You won't lose your collateral, but I think you'll lose your position.

MR. COX: That's a good point. We keep talking about triparty as though it's a silver bullet. In all of our derivative counterparties that we use triparty arrangements with, there is still the risk that the position that you have with that dealer losing your favor while you're trying to replace it and you incur costs that way so that this idea that somehow having a triparty arrangement with one counterparty totally eliminates your counterparty risk I think is a little bit disingenuous. It really doesn't.

The other thing I'd say is I don't think anyone is suggesting a model for cleared derivatives where we do bear customer risk. I thought that was off the table. So we spend a lot of time talking about fellow customer risk. I thought what was being proposed here was this LSOC model where that's been eliminated as long as you think it works.

MR. KAHN: I think no matter where we end up in terms of segregation, I think as an FCM as Bob suggested, Barclays does agree and would be willing to show our risk- management procedures and policies, and we do talk to our buy side clients about that. One thing where we are extremely cautious and will continue to be is client confidentiality in the NDAs. This is a big concept that when buy side firms are looking at FCMs to provide clearing services, we are often and I'm sure my colleagues from the FCMs are asked who also do you clear for. We have not said any time a specific client that we are providing clearing services for so that if Barclays is providing clearing services for any of the individual firms on the other side of the table, we do not say that, nor would we ever give out any position level information. It is very important to us that in whatever paradigm it's set up and how you evaluate from a risk-management standpoint that the buy side and their trades that they've put on that we are serving remains confidential and does not leak to the market in any side.

MR. WASSERMAN: Just to be clear, if on the other hand somebody from the clearinghouse came and said you're a member. We're auditing you. We're reviewing your work. We need to know this kind of information. Is that information that they would be able to get?

MR. KAHN: To be honest, I would have to go to my compliance team and legal team. Just someone showing up and saying I'm from the CME, I'm from ICE, that would not be enough. Once it was cleared from compliance, we are going to take so much caution on that, I can't tell you. So, yes, from a regulatory standpoint whatever is acceptable to the community is fine, but we will guard our clients' positions with tremendous emphasis.

MS. TAYLOR: And we don't tell either. So when we know when people clear, that's very confidential information and I'm very sympathetic to the fear about fellow customer risk, but I'm also very sympathetic to the fact that none of you would want your information disclosed so that there is a balance on the other side and I think there are probably ways to get some disclosure that would be anonymous and reflective of risk profile without being reflective of exact client mix. But again I heard both of you loud and clear.

MR. PRAGER: We are not a proponent of that. We're a proponent of the proposed rule and we don't have to worry about that.

MS. TAYLOR: You would have optional physical segregation.

MR. WASSERMAN: To be clear, Kim, I know

you folks don't disclose things, but when the Dow Michael's people or Ann Begin's people go in, they do get access to information that cannot for confidentiality reasons go to fellow customers.

MS. TAYLOR: Yes.

MR. MAGUIRE: An important distinction to make as well, we do keep talking about the bilateral arrangements and I think it's been raised, but to make sure everyone is very clear, you have protection for the collateral and you hold out for the P&L on your positions, maybe for your independent amounts as well, but then if that broker goes into default, you have replacement costs and that's the difference here that we're talking about with clearing, you do not have to replace your position. We just talked about $600 trillion long dated illiquid markets, highly volatile, you do not have to go into the market and place -- that's the insurance you're buying here rather than anything else.

MR. RADHAKRISHNAN: Let me ask a question about the bilateral arrangements. Jim, you mentioned the triparty agreement and Ritchie you had mentioned that as well. Essentially if you have a trade with a dealer and the dealer asks you for collateral, if I understand you correctly, you put out the collateral but it goes to a third party who holds it. The question I have is legally how does that party hold it? Does that third party hold it in trust for your counterparty? Number two, if there is a default or if your counterparty goes bankrupt, you mentioned that in Lehman you got your money back. How secure is that? In other words, is that purely a contractual right which a court cannot touch? Or is it so secure that in the event of an insolvency you're very comfortable that the money will come back?

MR. HARSHAW: The way the account is set up is when we have collateral to post, the custodian which is a third party unaffiliated with either one of us will open up an account in the name of the GM Pension Plan for the benefit of the dealer. The collateral that's posted is ours and remains in our title. We're the legal owners. They're a beneficial owner to the extent we default, but if we don't default it's still ours. Similarly, if the dealer has to post collateral, the custodian will open up an account that says X dealer for the benefit of the GM Pension Plan.

In an insolvency of either one of us which for pension plans is not something that can happen, in the insolvency of the dealer what happens is that we then have the ability to close out our trades and under the agreement subject to bankruptcy law we're able to pull back that collateral in payment of the amounts owed. So, yes, we are very confident that that works and it has been tested not just in the Lehman situation but for other counterparties that have defaulted over the years.

MR. THUM: To add to that, these are control accounts under the UCC so there is a perfected security interest in the assets held in the account.

MR. RADHAKRISHNAN: By you?

MR. THUM: By the secured party.

MR. RADHAKRISHNAN: The secured party, so the secured party has a security interest.

MR. THUM: A perfected security interest. They would deliver a notice of exclusive control to the custodian if the pledger experienced a default and they closed out the ISDA and the security's intermediary would transfer the collateral to the secured party. Likewise, the industry is working through documentation so that the pledger is also protected in the event the security party suffers a default so that the pledger can get the collateral back by sending instructions to the securities intermediary. So it's within the regime of the Uniform Commercial Code, well established to create the perfected security interest.

MR. RADHAKRISHNAN: The reason I ask you these questions is what you're trying to do, and let's be frank, you're trying to replicate what you have in the bilateral world in the cleared world. Right? That's what you're trying to do.

What I want to know from the FCMs and the DCOs is can that be done, one? Number two, if it can be done, how much does it cost? And number three, how long does it take? Because the one thing --

MR. WASSERMAN: May I add a fourth?

MR. RADHAKRISHNAN: Yes.

MR. WASSERMAN: Is that equally effective to protecting your ability to access that money in the event of a default? For instance, one question in mind as I'm thinking about this is there are security interests, so as I understand it, your counterparty has a security interest in the amount you've posted with the third party. My question is, is that a margin payment within the meaning of the financial contract provisions of the bankruptcy code such that essentially they don't need to do anything to enforce that security interest, they can just grab it. In the event of your bankruptcy, essentially do they have the money or do they have to go and get the money? Then the questions goes to you folks. Are you happy with money that is not in your possession but, rather is held at a third party in which you have a security interest?

Mr. MACFARLANE: Can we be clear that we're talking about initial margin and not variation?

MS. TAYLOR: Right.

MR. RADHAKRISHNAN: One more point I wanted to add is in the bilateral world there is just one party asking for collateral and that's your counterparty. It's both ways, but let's saying you're being asked for collateral. In the cleared world, there are two parties and they're not related to each other. In other words, there's the firm that's asking you for collateral to protect itself, and then there's the DCO that's asking the firm for collateral. How does that change the whole dynamic? That's what I'd like to ask.

MS. TAYLOR: Ananda, I think to answer some of these questions, I doubt that right now the way these things are structured they would fall under the Commodity Exchange Act as margin payments because they're bilateral transactions, but I would assume that the documents could be written in such a way that there was an acknowledgement in the document that the payment was margin under the Commodity Exchange Act and if there was a default it could be seized as such, so I think you could get around the legal distinctions about it. From a clearinghouse point of view, there are definitely two ways to structure it and I don't want to get in front of what the dealers might prefer. There's a way to structure it where the dealer has the account for the most part and then it only becomes the clearing's lien when it is passed through because they might have more collateral. You might need two accounts. There's definitely a way that you could make it work. I think that from a clearinghouse point of view I feel like it gives the customers better protection by far than the LSOC model because it is absolutely clear at the time and it is clear to the clearinghouse whether or not that customer defaulted and you don't have to unscramble eggs. So from that point of view I think it gives the customers who are using it much better protection. I think it costs more and so I would hesitate to have us set up an environment where every customer had to bear the cost of that if they did not feel it was worth the tradeoff and where the dealers would have to bear the cost of that for every single customer that they had instead of customers of whatever the appropriate scale would be and the same thing for the clearinghouses.

MR. FRANKEL: To make a point, I think the collateral what we're talking about would be DCO eligible collateral which is a restricted set of collateral. If you have in mind a whole range of collateral that you now post to dealers, it's not that.

MR. PRAGER: Kim, a point of clarity, if I may. You're saying it's superior to LSOC and it is legally segregated. How does it then fit in the waterfall? How does the current FCM model treat that subject to the waterfall?

MS. TAYLOR: Right now it's not allowed under the waterfall so in the world where there was physical legal segregation, the way I would see it is the customers who had the physical legal segregation, think of them as pools of their own and they would make settlement on an individualized basis so it would be clear whether or not they defaulted. And if the customers who didn't chose that option, if one of those customers defaulted, that would be a pool and it would be managed as such and the customers over here in the separate pools would be free to port without having to do wait to find out if there was more money coming or figure out which one of them actually was the one that drove the default. If you have enough money in your account to meeting your obligations, you didn't default to the clearinghouse. You can pick up and move somewhere else, and believe me, we would be helping you to do that if you needed help. Because it's in everyone's best interest that as many customers as possible to not have their trading disrupted, not lose their hedge and not lose their collateral. So we're all very aligned in that regard. The uncertainty of the LSOC model is where it becomes harder for me to be comfortable that you would get what you want.

MR. PRAGER: You had a bankruptcy debate prior? First of all, this doesn't exist today so it's not an option.

MS. TAYLOR: Our attorneys feel like it is. I don't think that they've been able to convince the CFTC, but I think there's definitely room for discussion. There is definitely viable interpretation that says that it's okay.

MR. WASSERMAN: To be clear, you mentioned your attorneys think that it is and of course we got something from Mr. Salzman who said he was speaking on his own behalf and not on yours. But in any event, beyond that which is on our website, is there any other analysis that you're aware of that explains why this would work?

MS. TAYLOR: I don't know that we have shared anything else with you, but we certainly would be happy to. One of the other distinctions, and I'm not a lawyer so I'm at a disadvantage in having this conversation with you, is that the ratable distribution only applies to things that are defined as customer property and I don't think that collateral like this in these third-party accounts held at a clearinghouse would necessarily be customer property. Therefore it's not subject to the ratable distribution.

MR. WASSERMAN: To make that clear, what you're saying is customers would be posting this collateral but it would not be eligible for treatment as customer property under the bankruptcy code? There's a bit of a bitter with the sweet issue. That is to say, the bitter is that the ratable distribution, there are some sweet things about being treated as customer property and protected as customer property under the bankruptcy code and so I guess the question is --

MS. TAYLOR: In this circumstance what would those be?

MR. WASSERMAN: Essentially, for instance what we saw with Lehman, that instant transfer where essentially there was this separate estate that got to be transferred out without waiting for essentially the bankruptcy process to work its way through and people eventually collecting. Customer property essentially can be moved. For instance, with 764(b) we get to approve and we have by rule and could by order approve transfers which are then not subject to claw-back, things like that. Those are good things that customer property benefits from.

MS. TAYLOR: And these are things that I presume that you --

MR. HARSHAW: Bob, I think you've hit the nail on the head, that you by regulation in terms of the analysis, we did have a law firm look at this and the viewpoint was that the bankruptcy code requires that the distribution of customer property be done ratably. Ratably is focused by Part 190 which provides that ratable distribution is done by customer class and then the customer class is actually done by you and in your adopting release that created the concept of customer class, I'm quoting, "The reason for identifying classes of customer accounts is to permit the implementation of the principal pro rata distribution so that the differing segregation requirements with respect to different classes of accounts benefit customer claimants based on the class of account for which they were imposed." The customer account categories are such that there is broad flexibility. For example, you've got an account for a leveraged account. That's not based on who the customer is, it's based on the type of account strategy that's being employed. We think you have the regulatory authority to make a customer account for those who pick full segregation. We also believe you have the regulatory authority to deal with the customer property issue that you were just talking about. So we do think that there is flexibility to take this triparty.

When we talk about costs, let me take a

second on that. There exists today these custodian accounts. It's a contract. Under the CFTC regulations we're going to have to realize all of our derivative contracts so we're already there. There is no more additional cost. One additional thing that we could do here in our contracts is to revise is to give the DCO direct access to that collateral. We could provide it in a way that accomplishes concerns from systemic risk not adding any more accounts because they already exist and we would give the FCM the rights that it needs and would give us the third-party recordkeeping, reporting, et cetera. One of the great things about internal controls is it says separation of duties. One of the bad things about the futures model is there is no separation of duties. The DCO relies on the FCM and many of the clearinghouses to tell them what their customers' exposures or collateral is. The FCM tells us what our reports are. The great thing about this model is it permits everybody, the DCO, the FCM and the customer, to get transparent reporting and still keep costs down because those accounts exist and all we have to do is change the contract which we already have.

MR. WASSERMAN: Speaking to the bankruptcy point and this of course came up earlier this morning in terms of whether the account classes work and folks expressed a great deal of confidence in our ability to pass regulations that would make that work. Back 14 years ago, Griffin Trading went bankrupt and there was a challenge to our rules under Part 190 which said that we've got to count everything as customer property. And Judge Katz in the Bankruptcy Court in the Northern District of Illinois said, sorry, CFTC. That rule was beyond your powers. So having been through that and been part of that, you can understand why I've got a little bit of a concern to make sure that we don't to beyond our powers and start putting things in the regulations that are beyond our powers and then people rely on them and the industry builds up a structure around that and then a bankruptcy judge chops it down and then all of a sudden all of the things that folks are counting on aren't reliable.

MS. TAYLOR: The Griffin example, wasn't that the case where we were trying to have the customer as a class be a preferential creditor to everybody else for everything else the firm had? It was not a question of there being a question about the things that were actually customer property.

MR. WASSERMAN: That was the facts of that case. But the point I'm making is that if we go beyond -- again the bankruptcy code has a structure and part of that is 766(g) and the ratable distribution and so the challenge then won't be from other creditors against the customer creditors, but it will be between customers and subject to the same thing where you have somebody who's not getting what he thinks he should and he thinks that the law entitles him to going and challenging our regs and bankruptcy judges who in my experience are not always entirely enamored of our regs looking at them and being able to say -- maybe they'll say, yes, you got it just right, but on the other hand it's also possible they'd say, sorry, you've gone beyond your powers, and if that were to happen then in the middle of a bankruptcy we have essentially a change. One of the things I've learned in terms of the implementation issues is the industry needs to build structures around our rules and you need to implement them and it's going to cost people a lot of money and time and if we put out a rule and it gets undercut, first of all, it would be undercut at the worst possible time and secondly it would undercut what might some very expensively built structures so that that is the reason for caution.

MR. MACFARLANE: Bob, having heard that there are different legal interpretations from different lawyers who are advising the firms around this table, that's a risk that we all take just like market risk. Again wouldn't it be better to give the market participants the choice and let them decide which risk they'd rather take?

Would they rather take this legal bankruptcy risk or would they rather take the omnibus risk? And then let the market decide where it wants to allocate its resources and then in a way disclose that this risk exists but not warranted.

MR. RADHAKRISHNAN: The concern for us is if we take the legal risk and you have a catastrophic insolvency then it would have an outcome on market operations that nobody wants. I'd like to know what the DCOs think about this because as Kim pointed out, in most of the issues that we've dealt with in the past 10 years, we've been lucky in that there has not been any instance where there was difficulty in moving positions. For example, in Lehman, we went to court and the judge agreed with us and everything went fairly smoothly. But what I think I'm concerned about is let's say we say, fine, you take the risk. You have customer choice and let's take the risk that the judge will agree with what we think. What happens if the judge does not? What happens with fairly significant firm which goes under and there is a great deal of uncertainty as to whether positions can be transferred or even worse, where the judge says no liquidated -- so that's the concern?

MS. TAYLOR: That is a real issue that everybody would need to think through and maybe it's a good point that everybody should have the ability to think that through themselves and make their decision. I got to believe that the contracts that are around these third-party custody accounts have the ability to stand up to bankruptcy issues anyway or they wouldn't have worked in the Lehman situation. I almost feel like we're going to have belts and suspenders in terms of the protection because there's the contractual provisions that stood up in a non-CFTC regulated bankruptcy and then there's the CFTC regs layering on top of it. I got to believe it makes it better and not worse.

MR. WASSERMAN: The question is whether they work together. One point I would make to try and get toward tying this up together is there are a number of views that have been expressed and some second hand in terms of lawyers, we're eventually going to have a comment period once the Federal Registry gets around to publishing. One of the things we would very much appreciate if people have divergent views in terms of the legal issues here is certainly if any one law firm were to file essentially a comment in the nature of an analytical memo that would help explain why there might be a divergent view, that would be very helpful. In other words, as a practical matter sitting around here we can't go too deeply into a complete legal analysis. On the other hand, a comment that says I think X is nowhere near as helpful as an analytical comment, I think X and here in detail are the reasons why.

MR. EDMONDS: Bob, do you have the same issue with LSOC as it's being proposed? Are you just dead certain and it's legally tied up that LSOC absolutely under no conditions could be misinterpreted or turned over in a bankruptcy proceeding?

MR. WASSERMAN: Here's why, because under LSOC at the end of it if you liquidate, what you would be giving back, the idea is you would have to give back to the trustee whatever is left of the collateral that is attributed to each of the customers. Thus the fellow customer risk would not be realized. Liquidity issues is a separate story. I realize that. But the fellow customer risk would not be realized because essentially you would be looking at those positions customer by customer by customer. That money would then go back to the trustee and the trustee would be distributing that ratably and there wouldn't be the fellow customer losses because that would be a ratable distribution. In other words, the intention, the design and again, are you asking am I quite confident? Yes. Is there basis for others to question it? Of course. But what I'm saying is that the intention was to design something that would work with the grain of the Bankruptcy Code, with the concept of ratable distribution rather than trying to get out of the

Bankruptcy Code and saying we're going to have something that we'll distribute it individually rather than ratably but to keep the ratable to protecting all of the customer collateral.

MR. HARSHAW: Bob, one of the things you talked about is the ratable distribution and as we noted before, that's by customer class.

MS. TAYLOR: Yes.

MR. HARSHAW: Those classes are already done. You've already established customer classes and so if there is a risk that that whole concept of a customer class won't be honored in a bankruptcy, it's not a new risk. It's a risk that exists today for every customer class that's out there. So if a bankruptcy court were to say that the CFTC does not have the authority to set customer classes, they could do that today. So we're not creating a new risk. It's a risk that already exists. In addition, those customer classes, you have the flexibility to provide as the release said for the concept of customer class to accommodate different segregation requirements and we really do think that the law is pretty clear, not unclear, that you have that authority and if there is a risk associated from different interpretations, it's a risk that we're living with today.

MR. FOLEY: I'd have to challenge that, sir. All this may have a certain amount of legal uncertainty to that, but the Commodity Exchange Act requires segregation of customers depending on are you trading futures, are you trading swaps. There is nothing in the Commodity Exchange Act that says you can establish separate segregation requirements for customers trading the same product. The Bankruptcy Code I think it may be accurate to say does not mention account classes, but it does define a claimant's right based upon whether or not it is a customer and it is a customer with respect to certain products. It is a customer that has a claim against an FCM if it's trading futures on a U.S. Futures market. It has a claim against a U.S. FCM if it's trading foreign futures. It has a claim against an FCM now if it is trading cleared swaps. Those are the account classes that I think the Bankruptcy Code contemplates. All this requires a lot more thought and a lot more detail and I think Bob's point about legal briefs or memos makes a great deal of sense and I think it would be helpful quite frankly if all of us had access to everybody's legal memos so we could sit around and really kind of hash these issues out. These are not simple issues and there are no simple answers to them and I think it is troubling. What I'm hearing over here quite frankly is you don't like the Dodd-Frank Act requirements and that's fine. If that's what you don't like, that's fine that you don't like them.

MR. HARSHAW: I don't think that's the case.

MR. WASSERMAN: To follow-up on that, Kevin you're quite right, I would note we did in the release at Footnote 91, I'm not sure where it's going to be in the Federal Register ultimately, discuss going back to the 1978

Bankruptcy Act House report how they were looking at different types of customers, separate estates for leveraged transaction merchants versus for options customers and again I think the point is we put Mr. Salzman's comment on the website very quickly and as we get these things in we would be delighted to have them, to read them and to put them very quickly up on the website so that to the extent there are differing views on this point they can be informed by the legal reasoning and we can do this on an analytical basis because of course there's a limit to how much we can do this.

MR. HARSHAW: Absolutely. One last point here. The Footnote 91 that you referred to refers to the CFTC thought there was a problem with separating classes other than by kind of customer in each customer class and the reality is that's already been done. For example, the CFTC created the deliverable account which is based on the method of settlement and not rather the kind of customer. There is also, Mr. Foley, across accounts. One of the customer classes is leveraged accounts which is to my knowledge not product specific.

MR. FOLEY: No, that is product specific and it's just a product that's not being offered.

MR. HARSHAW: Then I stand corrected. But the point is that we believe that there is a basis to do it on for example deliverable accounts on other than just the kind of customer.

MR. MAGUIRE: Bob, we started off on this path with what's the impact of this model versus LSOC for the DCOs and FCMs, so may I bring us back to that?

MR. WASSERMAN: Yes.

MR. MAGUIRE: Looking at it very simply at risk rather than a lot of the legalese around this, under LSOC the DCO has the money from the FCM from the customer in its account. Under this model it doesn't. So I know that one feels more certain in the first instance. Then let's talk about what are the impacts in terms of implementation and the impacts on the DCOs -- but in that construct it's not in our powers to hold that collateral so in our account is better than not in our account just being very simple about it.

Then you've got some operational complexity. If you've got 1,000 clients, they're likely to have more than one FCM, there's going to be therefore say three FCMs, therefore that's about 3,000 collateral accounts and you're going to have more than 1,000 clients one would expect and each DCO would have to have similar in each of the custodians and then you're going to have to talk about is it one custodian or more custodians. All of these things are achievable but there are layers of complexity and reconciliation work that needs to be built to be able to do this, so that there are those angles.

Then we also have to look at when you put your collateral into a custodian, you're transferring the credit risk from either the FCM or the DCO into the custodian as well. Custodians may go pop as well so there are assessments that would have to be considered around custodians as well. On top of that my concern with going down this route in the first instance, I think LSOC is one step toward it, but in the first instance of moving down this route is some people on the other side of the table I'm sure have very high-grade quality collateral that we would accept as DCOs. I would wager that not everybody on the buy side does so it could become a two-tier structure where those with collateral that is acceptable to the clearinghouse because you have to have acceptable to post it to the clearinghouse direct, they could use this kind of model, whereas those clients that didn't necessarily, they wouldn't be able to use this model unless we as DCOs went down the collateral curve, the credit curve and took less liquid creditworthy collateral so that by moving down this route it puts further pressure on the DCOs to take a broader range of collateral in -- so we just needs to be cognizant of where this would lead and also -- between some clients that have good collateral and some that don't.

MR. EDMONDS: I think, Dan, the last

point of it is the type of collateral under 125 is -- universe and not everyone represented by the buy side holds all of that type of collateral all of the time when they need it. There is going go be an unintended cost for that acquisition of that collateral if we're going to post direct through that and not use the intermediation factor through the FCM to get through there which is problematic.

One question I asked to ask is we talked about the LSOC model and you went through why you think it is better than the other alternatives from a legal structure perspective. Isn't it also theoretically possible that if we go through the liquidation and we do all the things that we have available to us in the toolbox in the time of stress, the loss to the buy side is going to be greater than what their fellow customer could be in that scenario by the time to go replace the positions, the P&L, the move and all that in order to get back to the net position that they were in before? Was there any thought around that in development?

MR. WASSERMAN: Let me answer that question and then what I'm going to want to do is have us move on a bit and then we might come back to this because later on on the agenda we're going to talk about specifically operational costs and risk costs and maybe after we talk about those turn those back and talk about optional models in those terms. But in answering your question, Chris, as I see it if you're doing things on an omnibus basis, then essentially there's enough money in the account or there isn't. If there's enough money in the account, then under model, this is Refco, this is Lehman, under any of those models it's just a matter of finding someone who can handle the book and transferring it to them but that's if there is enough money, in other words, if the loss wasn't from a fellow customer. But if there was a fellow customer, then I'm trying to see how there would be a greater loss to the customers if their money is at risk, how there could be a grater loss if their money isn't at risk than if you're entitled to look to their money, their collateral, their value, to make up the loss to the fellow customer.

MR. EDMONDS: I could be completely wrong about this, but if the fellow customer loss is a dollar on a pro rata share and we have to liquidate because that dollar is not there, so we the DCOs come in and we liquidate those positions, close them out, hand the collateral back, it's all there. Everybody is happy with the collateral. But because we liquidated those positions, they need to reestablish those positions for what it means to their book over time and it takes a few days to do that, and when they reestablish those positions they're in a worse off place than they were for their overall book for the buy side. Does it theoretically exist that it cost them more money now?

MR. WASSERMAN: I guess what I'm saying that's an apples and oranges to my mind and here's why. Essentially there are two separate questions. One is based on the circumstances are you going to liquidate? So if the loss was a dollar, I'm going to think under of these models unless the market was really, really bad you wouldn't liquidate. I guess what I'm saying is if you're comparing if we go under LSOC and we do liquidate versus if we go under the futures model and we don't liquidate, yes, of course it's going to be more expensive with the first than the second except I don't see how you get there because how is it --

MR. EDMONDS: You and Kim had the conversation this morning about are the customers in default or they're not in default and as a clearinghouse we have to make a decision within a finite period of time, and I'm proposing that they could be, and I freely admit that I could be wrong here, but the time value that is there, at that money in time that the clearinghouse makes that decision, you and I have had a conversation about duty of care from clearinghouses to members and to their customers over time, we make the decision to liquidate because we had no visibility to that other side. The net result is from a collateral perspective we're in a whole position, but from a market perspective the buy side ended up worse than the other.

MR. COX: What is the circumstance where you'd do that under the LSOC model and you wouldn't have done it in under a futures model?

MS. TAYLOR: I don't know that there's a circumstance where we would do it under the LSOC model where we wouldn't have done it under the futures model under the pooled model because the event is the same. The triggering event is that the FCM did not say so the way I have thought through the unintended consequences of how LSOC works, I think we're going to end up in a place where we're going to collect from the FCM the sum total of all the monies that are due and owing from all the customers who owe first and then we'll pay them the money that are due and owing to the customers who made money. It exaggerates the settlements and we can manage around that by letting the banks at least know the other side is coming so that they can net it off on a credit basis, but the FCM is either going to pay or they're not and then there is a decision and I think this is one of the decisions that would be also very challengeable by customers who don't think they were treated fairly, all the customers who owed us money, none of them paid and so if we decide that we're going to let some of them take their money and their positions and go somewhere else then I think we'll be in a position where we'll get challenged by other ones who would have though maybe they couldn't port, maybe they didn't find an FCM quickly enough. I don't think it's foolproof.

MR. WASSERMAN: On that last point I will note that we did, I think it was in 190.06, explicitly give you folks the power to do partial transfers and we mentioned in the preamble -- we reinforced the importance of your ability to do partial transfers.

MR. COX: My only point was that I agree, in an extreme case you might expect every customer who'd up on the day to be able to port to a new FCM very easily and you'd just be left with those that are down on the day and wondering whether they're going to meet the margin cost. That's kind of extreme. My only point was I don't see how this is any worse than the existing futures model, that absolutely you could have replacement cost for customers to replace positions, but I think you've got that in the existing futures model or the LSOC model. It's the same deal.

MS. TAYLOR: Actually I think it's the opposite because in the existing futures model you're absolutely going to get your positions. Your money might be a little behind and it might be short so it might be a pro rata distribution, you're absolutely going to get your positions because it is very clear that the positions can be transferred to another FCM at the current mark to market value. You don't take your equity with you necessarily, but you definitely preserve your position much more certainly I think in the omnibus model.

MR. WASSERMAN: Why so?

MR. COX: I don't see that.

MR. WASSERMAN: Because in addition to the issue that of course you'd need to be able to remargin because the transferee is not going to take those positions without the collateral and happily we've on to the next point on the agenda, portability, how is it easier to port the positions under the futures model versus the LSOC for an individual customer? Take your pick.

MS. TAYLOR: If you know who defaulted, you absolutely can transfer the positions of the nondefaulting customers in the futures model. You can't necessarily send the money right away, but I don't think you're going to be able to send the money right away in the LSOC model either because you need to liquidate it. The clearinghouse is allowed to liquidate the collateral and if the collateral comes up short, everybody takes a short payment on the investment list. The collateral can move. It will be circumstantial. It's not a guarantee. It will be circumstantial.

MR. WASSERMAN: I can understand an argument that it would be the same, but my question is I thought I heard you say it would be easier to move it under the futures model than under the LSOC and that I do not understand. Positions.

MS. TAYLOR: The positions? It's absolutely clear to me that we would move the positions of the nondefaulting customers at current market prices without money if the clients wanted them. So if the clients can find another home and can remargin their position, they can transfer it right away.

MR. MAGUIRE: I think that's the key, that they have to remargin so they'd have to double margin. That's the key point for a period of time which is the same under both.

MS. TAYLOR: For a period of time.

MR. COX: Why wouldn't you let them do that under the LSOC model?

MR. MAGUIRE: You could. It's identical.

MR. WASSERMAN: Why wouldn't you do that under the LSOC model? Put for the moment the margin aside.

MS. TAYLOR: I could do that in the LSOC model for the customers who made money the day of the default, but I can't do it for the customers who lost money the day of the default because every one of those customers technically has defaulted and until I find out if I can get more money from any of them, they have all not met their obligations to the clearinghouse, therefore I have an obligation to preserve the right to take the actions that protect the rest of the clearing members from exaggerated losses from not taking advantage of the ability to do liquidate the positions of all of the defaults.

MR. DIPLAS: Kim, I don't get this. Why can't they default in the omnibus model? What's the difference.

MR. MAGUIRE: It seems to be a double-standard.

MR. DIPLAS: I think you know that these

four people that paid the money or you don't.

MR. KAHN: And to go one step further, I think all three of the FCMs, there are more than us that are shaking our heads, if we're a good-standing FCM we cannot take the positions without money coming with it because we're going to end up with the positions that we are then going to own and the margin may not travel with us.

MS. TAYLOR: Clearly the client needs to remargin.

MR. MAGUIRE: I think the key to all of this is that DCOs who take good collateral can take the right hair cut and this whole thing disappears.

MR. THUM: I think we're trying to understand better how one client's default gets attributed to multiple clients who have performed and if there is some technical glitch in the drafting of the proposal because I can't imagine that was ever the intention of the drafters and it certainly wouldn't be our expectation in supporting LSOC which we do. So I think we should try and identify what that glitch is because I cannot imagine that any of us wants the default of one client to tar the rest of the client base that has performed.

MS. TAYLOR: The way the thing reads right now, by definition people have not performed if they haven't paid so the clearing member either pays or doesn't pay on behalf of the losses that it suffers to the clearinghouse which is likely to be the sum total of all the losses that its accumulation of customers suffered. So every customer who lost money the day that some customer's failure causes the FCM not to pay is by definition not in compliance with the requirements to have paid their P&L. So there will be a period of time where we try to get that money so we can make sure that that customer is whole before we would be willing to transfer I think. It will be circumstantial, but I think you'd need to make sure whether or not you had a customer who was or was not a defaulter. It's harder to determine which customers were or were not defaulters than I think it is in the omnibus model.

MR. WASSERMAN: So Kim, under the omnibus model, if I'm a customer, I've got certain positions -- first of all, if you don't know me until I -- in other words after the default you don't know me until I introduce myself, but those positions may have lost money on the day of the default. You haven't gotten money for them. So in fact under the omnibus model I'm not sure you know anything about me other than what I tell you and indeed my positions may have lost money, but I still want to transfer them because I had already paid the FCM and I promise you that's the case, but you don't know that. Under that case I think if you're willing to transfer me then you're willing to transfer me despite the fact that there was a default that touched my positions.

Switching to the LSOC model, we did put in things there to make it clear that if I had, again using my example from this morning, $1,000 worth of collateral attributable to my positions and those positions lost $100, CFTC is not going to force you to give me back $1,000. You are perfectly free to apply that $100 against the $1,000. That doesn't mean there is any reason for you not to transfer those positions and $900 to another FCM, and I'm not sure why you would have any greater right or incentive to do that on the LSOC model than under the futures model or refuse to do that.

MS. TAYLOR: I think it's because the way that I read it we're making a decision that potentially makes the loss that is mutualized across all the other clearing members worse versus one that doesn't change the position of the loss that is applied for all the other clearing members. Remember we're trying to balance the systemic risk containment of not bleeding losses over to parties who are not the defaulter. So in the case of a pooled regime where I am entitled to use all of the collateral that I have, if I let positions go with no collateral because customers want to put their positions, have gotten rid of exposure without collateral, I have not worsened the loss that's going to go across all of the other clearing members and I have more flexibility to do that. I might not always be able to do that because it might be that all of the positions that want to move actually do worsen the ability to liquidate the portfolio, but I have better flexibility to do it because I'm not worsening the loss. Whereas if I let a customer who didn't meet this obligations and I would have had the right to liquidate his collateral and his positions in order to reduce the losses that the other clearing members would suffer, I might be making a decision that worsens the loss.

MR. WASSERMAN: We're not talking with recourse. So essentially at least the way it was meant to be written and if it was imperfect, mea culpa, but essentially I've got a set of positions, collateral of $1,000. I've got credit for that. There was a loss then of $100. So what you have is you can take that $100 out of the $1,000 and if you transfer the positions then I'm not sure how any of your other members is made worse off by transferring the positions to another FCM. And again you're taking that $100. That's what I owe you. You're taking it out of the $1,000, only transferring the $900. I'm not sure how you're making any other member worse off.

MR. MAGUIRE: Bob, can I give you an example? We have this model live in Europe and we test this and I can tell you how it works. I'm going to pick on the three gentlemen there, Ritchie, John and Rupert. I'm going to pick on Ritchie and say he's the defaulting client because I know that will wind him up. In that instance you have a client that's taken down a clearing member. Each of these individuals had a risk of $100 and it's collateralized at $100. I can't care whether it's T-bills, corporates or whatever. I have a collateral value - you're giving me $100 each. In each you have a mark to market on your portfolio of $50. So at the point of default John says he wants to go to another clearing member because he's a legally segregated operation, they're commingled, I say to John, you've got $100 and your mark to market was $50, but by the time you port to your new FCM, the market has moved to $55 so you've got to make good on that $5. Let's go the other way around, $45. You've lost $5. So I migrate you across. I say you go to another clearing member, Ray maybe, I'm only going to take you if you give me the $100, but also he really insists you must make good on the other $5 lost that's accrued in the period of time from the default until such point you've paid the VM. I'm going to do the same Rupert. Rupert wants to go to a different clearing member. He's lost $7 so he's now down to $43. We go okay, you're going to go to one of the other FCMs. We take you with a collateral value of $100, not the same piece of paper you gave him I'm afraid over a year ago. And then Ritchie, we're going to close his portfolio out. Now if the situation arose whereby when we liquidated that collateral we didn't get a value of $100 for John and a value of $100 for Rupert because we'd haircut incorrectly, under the European model we incur that. That's actually a loss borne by the clearinghouse and the defaulters -- so we say we're confident in our risk management. We will take hair cuts. We'll price the collateral on a daily basis and we expect to be able to close the collateral out within the assumptions we've got in our risk, and if we don't that comes out of the waterfall. We don't actually redistribute that across the clients so there's no investment risk there as such is what we call it. That's pretty much how it works in Europe and how we test it.

In the U.S. model that's being proposed here, if we did have a reduction in the value of the collateral and there was a loss, we'd expect those guys to still port, we'd take their positions, but let's saying rather than having $100 it was $98 because we've miscalculated the hair cut, we'd ask John and Rupert to pay an additional $2 to Ray and the other FCM to make good on that. We're not going to not send them because they've only got $98 and not $100, we'd send them across and they'd have to make good to make that successful as a transfer and if they didn't, we'd say, sorry, you can't go and then it's either pay or we'll liquidate. So that's how it would work in either the U.S. or the European. One way to take this issue off the table is follow that similar model whereby it's the clearinghouse that bears the risk and has to have confidence in its hair cut collateral, et cetera.

MR. THUM: Dan, what you were saying seemed to be that Ritchie had defaulted, there was a market loss on the other two positions. Kim was saying she wouldn't port any of them because of the combination of the default and the market loss so you couldn't therefore determine at that time who had defaulted.

MS. TAYLOR: The problem is that they would be defaulting clients where you would entitled to the liquidation of their collateral end positions if you needed it and you wouldn't know yet what you're going to realize on the sale of the collateral. You don't know what the loss is going to be.

MR. FRANKEL: That's sort of odd because they really wouldn't have to pay their part of the margin until late in the afternoon and you would consider them in default in the morning because the clearing member was in default in the morning. That seems a little odd. Certainly you'd like some assurance that it would be paid.

MS. TAYLOR: The clearinghouse has to make a decision as Chris was saying at a very specific point in time. That's why the mechanism because it's very clear when there is or is not a default and what can be done.

MR. WASSERMAN: I still don't understand, So again, you've got $1,000 of collateral attributable to me. There was $100 loss on that and there is the position remaining. I can perfectly understand your saying, Bob, there is no clearing member, there's less than $1,000, we're going to liquidate you because we don't want to risk further losses. I've got that so far. On the other hand, if I said, wait, Kim, Laura over here, she's a member in good standing. She'll take that position and she'll take it with the $900. I've made arrangements with her to get the $100. I don't see where the clearinghouse is at risk. You've got your $100 because you're taking it out of $1,000. So I'm still not understanding why it is you're not willing to let me transfer over to her those positions either with or without the $900. But why aren't you willing her to let her take the position? She's a member in good standing.

MR. KAHN: From this conversation it's important to come up with the most simple and easy to transact portability process. We have an extremely savvy, sophisticated group of people at this table and now we're trying to explain exactly how it happens. To Dan's example, if one guy went under and the other guys had $100 but their mark to markets were $5 million or $2 million and we're obviously in a market that's really not tremendously stressed, the fact is under the example if that were to happen, you're probably potentially going to have positions that are moving 60 points. So if you move a position at $100 million of IM and it moves two, then the other FCM is probably likely to take it because they're going to be able to look at and feel okay. The fact is if you have $100 million and it potentially moves 60 or you're really not assured where it is, then you run the risk of having a portability situation that could be extremely chaotic and it does concern people at Barclays. So I think no matter how we figure out how to do this, it's important that the market understands it and all the market participants understand it because when a port situation comes up again, hopefully it never does again in a basis, it's going to be in a chaotic market. If we are having this conversation, think about the people who have not spent the time and the focus to understand this.

MR. MAGUIRE: And I think that is absolutely why the DCOs have to be able to calculate risk, P&L, initial margin at the lost level on a client I.D. level because the FCM is gone. You cannot rely on it at this point. I need to know what every single client has got, what the P&L is so I can see and raise examples. The losing 60 of the 100, this is a big risk. I'm going to close that out unless they pay me that 60 now. That is absolutely fundamentally why the DCO has to be able to do this at the lowest granular level.

MS. TAYLOR: And it will be hard for you to give the customer the opportunity to make the choice to give you the 60 because you've got to have an arrangement in place with the customer the way you do in a physically segregated.

MR. WASSERMAN: I got to keep the discussion moving, I apologize.

The next point on the agenda is operational costs and I'm going to take Dan's comments as an opportunity to segue there because one thing that is very clear to me is that the clearinghouses under the LSOC model are going to have responsibilities at a client level, maybe not every client, maybe just those clients who are actually going to threaten the FCM, but that does raise at least some cost issues. What I understand you to be saying, Dan, is that you already look at the client level because you believe that's necessary even today even under an omnibus model. Kim, I understand you to have said earlier that under an omnibus model but for swaps because of your concerns about the products, you are also looking at an individual customer level. So my question is going to be first, Chris, I'm going to turn it over to you for a second and then ask from a clearing perspective are there material operational costs in going to let's start first with the LSOC model?

MR. EDMONDS: In our current model on the customer business that's been cleared, we say we collect -- already. We may not know the exact identity of who that is, but we know it's a client customer and we know it's a unique client I.D. of the clearing member that we have, and we know we're holding that collateral and potentially excess collateral being collected by the clearing member for their defined reasons separately and it's there and we close it out. I don't know that there are material changes in that although I would say it would seem to be based on the earlier comments made by some of the members on the buy side that that reconciliation process is different than what they're accustomed to so I think there will be operational requirements both from the DCO to the FCM to the end user, the buy side here, where that there will be changes in process today, there will be some associated investment in. I can't tell you exactly to the penny what those would be, but we don't route all that information back. We take that information in and as positions close out the money flows accordingly whether it be excess margin coming back, that the clearing member does something based on the contractual relationship and themselves.

MR. WASSERMAN: Let me turn to the firms for a moment. Again under one of the proposed rules, I think this is 12, you would be required every day to be passing information on individual customer exposures to the clearinghouse. My understanding is you already know that, but there would be a new thing and that you'd have to pass it upstream -- material operational costs from that, material operational costs from other things that I haven't mentioned?

MR. FRANKEL: From the swaps clearing I think passing the client identity and there is a multiplier or some other multiplier that explains how much excess there is in the seg account for the client, I think that's a small build. I'm concerned though if we're looking at cross-margining putting futures into the cleared swap account class. Since we don't today put a client I.D. on futures how that infrastructure would work. So I think there's a cross-margining issue, but for cleared swaps themselves, I think the build is fairly minimal.

MR. WASSERMAN: If you were cross-margining today and you were cross-margining between futures and swaps, wouldn't you need to have that at that individual client level to do the calculation for the client's required margin?

MR. FRANKEL: Yeah I think we can, it's just the cross-margining is not really done in that fashion, but if we're reporting it out, we'd have to set up the infrastructure to do that.

MR. WASSERMAN: Because you don't currently do that for client level?

MR. FRANKEL: We don't do it in that same fashion. We keep records separately in a different system so we'd have to submerge systems but it's not that hard.

MS. TAYLOR: May I ask a question? It's a little bit off topic. I think that the operational aspects of once a client went into the OTC pool to get cross-margining, I think we have foreseen treating them just like other people in the pool or other positions in the pool. So I think that we would be expecting that the client I.D. would be reported. But the real thing that Oliver triggered when he said that is for the cross- margining if certain customers are opting to go out of the pooled segregation for futures and still trading the same products but going into a different account class, it's a direct parallel to having people opt to go out of the OTC account class pool into a different account class that we were talking about with the physical segregation. That's just a thought I wanted to add.

MR. WASSERMAN: I don't think so because I guess in harking back to the 2008 interp that we did I guess for two reasons. All of the collateral then is margining in this case -- let's say you put futures into the swaps account class and indeed I think this is alluded to in 22.1, we're treating the futures positions and collateral as swaps positions and collateral and that's the nature of the 4(d) just as when we would do a 4(d) order today and we're taking foreign futures and putting in the futures account class or cleared swaps and putting in the futures account class, A, we're treating those positions as positions of the new host. Second, all of the collateral margins the positions in the host class. So if you're cross-collateralizing between swaps and futures in the futures account class, all of your collateral is margining futures and therefore could be treated as that. That's a different thing than saying we're going to be treating one group of swaps customers different than another group of swaps customers based on the choices they've made for protection.

MS. TAYLOR: But they just chose to get their positions and collateral treated as subject to this other different new account class as opposed to --

MR. WASSERMAN: No. What has happened is we have by order permitted these particular transactions to come into that account class and again the collateral regardless of whether it's margining futures, there are futures in that pool but there are swaps, otherwise there wouldn't be cross-collateralizing and therefore all of the collateral is margining swaps which is the nature of the account class that they're in.

MR. MAGUIRE: I think there are many points about cross-margining, that if you start putting swaps in a futures account you're going to have impacts on the futures default fund and all that. The cross-margining thing is important but it's not really what LSOC is about.

MR. FRANKEL: It would also affect the default management of the futures class which would have to go from a 1 day to a much larger time span so it would be problematic.

MR. WASSERMAN: Let me ask if any of the other firm folks have anything to say with regard to operational costs and then hopefully we can wrap this up in a few minutes and then I can permit folks to take a bit of a break.

MR. KAHN: Very quickly, Barclays is building what we hope to be a very flexible and dynamic system. On LSOC, we have been fully serving and clearing a client out of LCH since last year so we're set up to do that, not only whatever regulatory standpoint we up end up in whether it be in the U.S. or in the E.U. or across a country, our tools are extremely flexible and we will continue to build more flexibility. In terms of the cost, the fact is OTC is a little different than futures because there is a tremendous build that everyone is doing in the case of OTC so if we need to build LSOC which in essence we've done in the LCH European model, there is a cost of that but I can't really define what it is. It's relatively small and not material. It's part of the cost that we have to build. To make something similar in the U.S. in the FCM structure we can do. In terms of the various identifiers that we may need from a regulatory standpoint, we have worked incredibly hard to build a stand-alone system that does that and build out new things. In terms of risk managing, what we have to do, we understand we have the counterparty risk to our buy side clients and to get our buy side clients comfortable that we can handle this type of risk. We have to have all that stuff available at the legal entity level and we have to be able to manage it and we are well on our way to doing so.

MR. WASSERMAN: Let me turn briefly to the buy side. Let me tell you my understanding and please tell me where I might be going wrong. Clearly if these guys incur operational costs, those are going to find their way out of your pockets because they're going to impose them on you. Putting that aside, operational costs that you would incur separate from whatever you're paying this side, there are risk issues, but I don't see that there are operational costs. Please tell me where I'm going wrong on that.

MR. THUM: We think that operational costs could decline by entering into this model. Right now we have significant operational costs across our dealers to maintain the custody accounts, to maintain the collateral valuation of margining across the multiple dealers that we have and we see that narrowing and having a much more consolidated, efficient approach when we do this. So we see this as a cost sayings. But in any event, we're prepared to bear the cost to provide for the margin protection that our clients need.

MR. HARSHAW: Apologies that I use car analogies to a manufacturer here, but it's cheaper to make a car without safety features. It doesn't mean you want to. So, yes, I agree with what Bill said. There is less complexity to the LSOC model to the OTC triparty. Absolutely. Do we want it? No. I think one of the things that gets lost here as we focus on cost is we haven't talked about the benefit. CCPs which are going to be bearing these costs just got a monopoly by law. If it's a standardized contract, it's required to be traded on the platform and they're going to get all the business. They didn't have to spend any marketing money for it, they didn't have to do anything to get it and they're going to get it. Yes, they're going to have some costs, but they just got a windfall. Right now in our triparty arrangement, for years we've had dealers pay for the cost of the triparty arrangements. We didn't have to pay for anything. Why should that change now that we're going to go to a cleared model? We should be able to get what we've been able to negotiate in the past. So I think the cost needs to be also focused on losses. We will lose. We will be exposed to depending on which model gets adopted fellow customer risk, investment risk, transit risk, recordkeeping risk. We lose netting across products because of clearing. We have initial margin. We got lots of costs that we have to bear and nobody is crying in their tea about us. The point is that the costs really shouldn't be the focus. They're getting a windfall to get all of this business. They should incur the costs associated with that. We shouldn't lose anything as a result of it.

MR. WASSERMAN: I understand your perspective. Let me tell you where I'm coming from. Section 15 of the Commodity Exchange Act requires that the Commission before it passes a rule consider among other things cost and benefit issues. This is ultimately part of a rule-making process. We must consider cost and we're not allowed to just simply say they're getting some goodies from Dodd-Frank. What I'm trying to get on the record here and what I'm trying to understand is in fulfilling my obligation to the

Commission to help the Commission consider costs, we've separated out operational and risk costs and we're going to do risk costs after the break. I want to get the issue done with operational costs. Are there any operational costs that if we did LSOC versus say the futures model that would increase for the buy side?

MR. HARSHAW: Yes. The fact that I have to do things that take me a lot of time today doesn't mean that to get ready for everything else won't cost me stuff. In fact, I will have lost all the money that I spent setting up those things to provide protections. And you also mentioned that you have to consider benefits. The things that I just mentioned are the benefits that the CCPs are getting as a result of this.

MR. WASSERMAN: I want us to consider the benefits, but I'm trying to get an understanding with respect to the costs. So you're saying you would pay more. There would be additional costs that you would incur under the LSOC model that you wouldn't incur under the futures model?

MR. HARSHAW: What I'm saying is that the full seg model which is what we're advocating for as I think many of the people on this side of the table, that we have sunk money into it. That money will get lost as a result if we go to a model other than that. In addition, we will have to incur other money to get set up technologically for a new paradigm so that that is cost to us as well. So there's a loss of investment into operational investments we've made already for our triparty setup and then there's a cost for us in terms of getting set up for each of the CCPs, each of the FCM models in terms of how they're going to do it. So, yes, they are significant.

MR. WASSERMAN: There is a cost if we adopt the LSOC model versus a complete legal seg model?

MR. HARSHAW: Exactly.

MR. WASSERMAN: I understand that point and that is noted. My question is, complete legal seg versus futures. Is there an addition cost to complete legal seg versus futures?

MS. BREGASI: There is no additional cost between LSOC and the futures model.

MR. PRAGER: We don't see them incurring other than the start-up costs, the one time that everyone will have to incur to set up, the running cost. We don't see any incremental cost.

MR. MACFARLANE: I would agree there are no additional operational costs. However, there may be additional credit hedging costs which we may get to.

MR. WASSERMAN: We're going to get those right after the break. It is now 3:25. I think maybe since we've run over, can we get back very promptly at 3:40?

(Recess)

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MR. WASSERMAN: So ladies and gentlemen, I know a number of folks have flights and such and are counting on being able to leave at 5:00 p.m. precisely, so we've had our last overtime.

Okay. I think we're now going to start talking about risk costs, and that is, I think, going to be yet more interesting. And so the question I'd like to raise now is for each of the models: What are the risk costs? That is to say not just simply operationally but because of greater risk that may be imposed on various folks whether it -- you know, moving essentially risk from customers to FCMs to DCOs, what are the additional risk costs, how do you measure them, how is it that you're likely to allocate them?

MR. NICHOLAS: Bob, if I could just sort of start with the big picture, and we certainly can get more specific after that, but I do believe that there's a systemic risk cost to moving away from the future's model. I do think that it will result in FCMs electing not to maintain excess net capital because that excess is at risk. That excess can be pulled from them by the clearinghouse. It's a risk that they don't have control over, and so I think you would be left with less well-capitalized FCMs, creating more systemic risk.

MR. WASSERMAN: Let me ask about that. Right now we have, as you know, our net capital rule, and so I guess my question would be is the capital that we're calling for under our net capital rule sufficient or should we be changing that net capital rule to require increased capital?

MR. NICHOLAS: I saw that in the release. I don't think it's really right on point, though. And I know where you're going with that and that -- but I think FCMs are encouraged. I mean it's different to mandate it as opposed to needing it for good business prudence practices. I think the motivation won't be there anymore, and that's not to say that capital levels should be increased or reduced, but I just think the motivation won't be there.

MS. TAYLOR: I think what I would add to that is I don't think of -- I mean required capital is capital, but required capital and excess capital actually perform somewhat of a different function in the way that they help the clearing members protect the customers against the erratic behavior of other customers, right? You need to be in regulatory capital compliance, so raising capital requirements increases capital in the firm but it doesn't increase the firm's ability to be resilient to losses that would eat away at capital. You need excess capital to be in the firms no matter what the capital level is because they need to be able to maneuver and cover losses and still be in compliance with regulatory requirements. So there still is a need for it, and I think in a model where customers are less incented to care about the credit risk worthiness of their clearing members, and some of you have said that you still would be very concerned, so that is good. But if there were an environment where customers were not as concerned about the creditworthiness of their clearing members, I think that does probably result in a reduction in the balance sheet that parent entities would allocate to the future's business because there's not any competitive value for having it because you're not going to necessarily attract a different class of customers because the customers are less attuned to the balance sheet of the clearing member.

MR. WASSERMAN: But I guess the question I'm asking, the assertion is made that there's a systemic risk that because FCMs are going to be -- essentially have more capital at risk, they're going to reduce the amount of capital they hold thereby creating systemic risk, and I guess my question is if -- are our capital requirements then for that matter -- the DCO, of course they have capital requirements for their members -- are those sufficient? And if the answer is yes then how can we say there's systemic risk if people meet those requirements? And if the answer is no then why shouldn't both we and the clearing organizations be increasing the capital requirements?

MR. FRANKEL: I think the first line of defense that we should talk about at first is what initial margin requirements there would be because once we've understood that then I think the residual risk will become clearer, become sorted out. So if we start with initial margin under the different models, we put in our common letter -- is the common letter a heuristic which for the future's model margins levered at something like 99 percent, five-day coverage and so on. Moving to a 99.9 percent confidence of coverage we think will increase margins by about 60 percent, 60, 70 percent --

MR. DIPLAS: For rates.

MR. FRANKEL: For rates, yes. This is just for rates. I think for a CDS it could be more than double. I'll let Chris talk to that. But going back to rates for a moment, the 60 percent increase is somewhat demonstrated by the CME's current margin system, the one they're about to use, which is very similar to LCH's but which charges -- where the 60 percent number is demonstrated for -- that's three points -- is the margin for a ten-year swap, and for LCH it's five points which is I think very much in mind with the claim.

MR. WASSERMAN: And is that essentially going from a 99 percentile to a 99.9 percentile?

MR. FRANKEL: Very much that. It's slightly different, but very much that.

MR. MACFARLANE: But does that accommodate which model? The going from baseline to LSOC or going from LSOC to seg?

MR. DIPLAS: Yes. To LSOC.

MR. FRANKEL: Okay. LSOC to seg I don't think is any real change in IM requirement from -- from LSOC to complete seg or full seg.

MR. MACFARLANE: Yeah.

MR. FRANKEL: But going from futures to either of the two is a 60 percent increase as far as we can understand it.

MR. MACFARLANE: Well, that in itself is

an interesting statement about the degree of mutualization or risk that is occurring, so you just in essence -- and you're asking us on this side -- I guess those of us on this side of the table would benefit in the short-run by having to put up less collateral, but what's being said, if our transactions had to be margined on an individual basis it would require that we put up 60 to 70 percent more, which says that then the real risk of that transaction is 75 percent more than what we're collateralizing. So in the event of a default, not by us but by another counterparty potentially, they will be under-collateralized relative to what their individual transaction would require, and then that potentially could work its way back to us.

MR. FRANKEL: It's true, but here's the rub on that. The diversification in the client account is so great across customers, in the future as well -- in our future client account, one individual client does not comprise very much at all of that account, and so the fellow customer risk gets shared across so many other clients that it's de minimis loss.

MR. PRAGER: That's the theory, but again --

MR. FRANKEL: Yes.

MR. PRAGER: That's the theory, and I believe it's the CFTC's own work that demonstrated the reduction of that client collateral in the case of Lehman, so that's a theoretical diversification --

MR. FRANKEL: Oh, totally theoretical. Absolutely.

MR. PRAGER: So we have to be really careful.

MS. TAYLOR: But the exposure went down in Lehman, too. That's the thing that everybody's leaving out of the picture. You want that to happen. That's part of why the risk management regime works is that people have an incentive to leave a firm that is appearing not to do well.

MR. PRAGER: Yeah, but --

MS. TAYLOR: And they take their

exposure with them along with their collateral.

MR. WASSERMAN: But Kim, are you guaranteed that the people, that the exposure that will be leaving is not the exposure that causes the default?

MR. FRANKEL: Let me just continue my -- what we found was that the closeout cost in the future's model was the most expensive. I mean closing out a client account and rates could be extremely devastating to the market, and of course we're thinking losses, replacement costs of the order of six to ten or more times the amount of fellow customers, so they'd be really significant losses, and any way they can be avoided would be beneficial to every participant in the market. To think of a large financial end user losing all its hedges could be catastrophic to the taxpayer, too. So we're really concerned that there is a weight to port, and any weight the people -- the clients can port out. Any model that provides that is superior to one that doesn't.

MR. MACFARLANE: I think that's probably

more a matter of perspective because not only -- again, systematically if -- first of all, was that analysis conducted on existing cleared products or perspective cleared products, because my guess is perspective cleared products are going to be more volatile and the multiplier is probably going to be in excess of that 60 to 70 percent. Again meaning that -- let's say that it goes to 100 percent, that the market --

MR. FRANKEL: Yes. That's for what is about 60 for CDS. I think you're measuring at a hundred and something?

MR. DIPLAS: CDS. We talked about --

MR. FRANKEL: Yes. So, and swaps are even more so. So you're right. Absolutely.

MR. MAGUIRE: The more of them in you get the bigger the number.

MR. MACFARLANE: Right. So again, we're inviting then counterparties to participate in a mechanism that requires that they not put up enough collateral or capital to support the risk of their stand-alone instrument. And so again, are we building a house with toothpicks or shall we be looking for something that's going to give it a little bit more strength when the storm comes up. And maybe these transactions should be required to stand on their own in terms of the collateral that's put up, and that way then you spread risk appropriately. You don't encourage an institution to take more risk than they should because they can.

MR. DIPLAS: We agree with you. The important building elements here are both to have the appropriate level of collateral but also to have the mechanism to ensure the portability. The portability is what is basic. And I think all of this point was not I would prefer it if it was the baseline model, but it is if we do not have portability the cost associated with the unwind would be higher than the fellow customer risk port probably. I'm not saying that we prefer that. It is fundamental that we build the portability and have structure that actually allows the portability to take place. That is the only point.

I think for summarizing what all we were saying is that not having the additional pool of funds that are associated with the fellow customers means that we definitely need to actually margin from a CCP perspective, the higher confidence interval. That will differ depending on the asset class we're looking at. Some of them, at least based on the existing pool of trades, it could be manageable like at 60, 70 percent in rates. We'll talk about three to four times the amount that -- in credit -- and the more we get to instruments with fatter tails the higher the number is going to be. I think that is something that clients need to be cognizant of. I think like you said a lot of people might see that as an actually very reasonable trade-off basically and accept that. But those are I think very basically kind of the choices that we have to make here.

MR. COX: But --

MR. WASSERMAN: So let me press on that

point just for a moment because I've seen from the comments some folks talking about increases in margin, I've seen folks talking about increases in guarantee fund, and so what I'd like to get to is how would you determine how much additional margin, how much would you -- how would you determine how much additional guarantee fund, and also very importantly, how would you determine the mix. In other words, are the numbers we're talking about A or B, you know, is it both additional margin and additional guarantee fund, or is it A or B, or how are you going to combine them? So --

MR. EDMONDS: It's a balance. It's a balance. I mean I don't know that we can -- I mean certainly in our comment letter we went through and we took every one of our existing portfolios. Okay. And we took them at the 99 percent competence interval there today and we scaled it up to 99.9 to show you what the difference would be based on a factor. And if a factor of one is 99 percent, the average for CDS at 99.9 percent was 3.7. So a 2.7, 270 percent increase if you want to think about it that way on average. Some are higher than that.

But as we walk through those pieces of that puzzle there are other considerations that this agency doesn't impact. As we relate to our membership at the end of the day and the constraints that they have placed on them by other regulators that may have some insight, some control over. So to give you an answer on that question of what it would be, you know, to determine that balance I've got to figure out what bank capital charges may be for some of the entities that will be faced with that in order to give you an adequate picture at the end of the day.

Or we can just say, you know what, we're going to reduce the guarantee fund because we're going to go to 99.9 percent as other models represented here have, and at that 99.9 percent we're going to have a very limited guarantee fund so that mutualization rests like -- if initial margin doesn't cover it, and you know, we can show you all the models there and these products that historically haven't been cleared or have just recently began clearing and say this is it, and we believe we're right, and chances are we are. But the cushion that you have in the intermediated model that we have today won't be there anymore. So that's the tradeoff that you're going to make in that type of assessment.

MR. WASSERMAN: So here's --

MS. TAYLOR: And that is an important -- is a mixed decision, and I agree that you can make different mixes and make them work and you can't really call it right now until you see the portfolio and the conditions and the regs and the capital rules and everything that's going to be -- that you're going to be facing. So nobody can make a call on exactly how they're going to do it. The problem --

MR. WASSERMAN: And I'm going to say -- just --

MS. TAYLOR: The problem is if you go --

MR. WASSERMAN: -- second --

MS. TAYLOR: -- if you go too far in one direction --

MR. WASSERMAN: And I'm understanding part of that is because of the bank regulators as well.

MS. TAYLOR: And if you go too far in one direction and go higher, higher on the margin you can do that, and you could go lower on the guarantee fund, and up to a point that is fine. There is a point where I actually think going below a certain level on a guarantee fund is improper systemic risk containment behavior by a clearinghouse because a margin is based on an estimate that's based on your statistical assessment of what the worst-case loss is going to be tomorrow, and it might not be that. It might be worse. And so that is why margin needs to cover the tail risk -- or the guarantee fund needs to cover the tail risk event that could happen beyond the margin, I think no matter what kind of statistical estimate you use to cover the margin.

MR. DIPLAS: But you use different -- hold on. Just to explain how we got here, the mix we chose on the credit side was determined when we had only direct clearing members and not clients. Because of the fact that also the credit asset class we initially went with more mutualization, that as a result increase the guarantee fund contributions and decrease the initial margins. It is very difficult to pass these costs on -- the moment we do to these clients that actually don't -- are not exposed to that mutualization, so perhaps they -- the model going forward would be one that's going to err on the side of initial margin versus guarantee fund. That is actually consistent also with the way I think also international regulators in treating the guarantee fund contributions of clearing members, and if the current proposals under Basel go through they're going to make it extremely punitive to actually have guarantee fund contributions. So the incentive would be to reduce those and therefore you will see a very large increase on the initial margin levels.

MR. KAHN: I think the concept here, to make it simpler which is what we've done is this pitcher represents the amount of margin, the water that needs to exist. Okay. If you take out the mutualized part you end up with what I'll define as an hourglass. Right. And in the hourglass the top part is what the buy side pays and on the bottom side is guaranteed fund and the CCP contributions. Okay. So a lot of the conversation we usually have talking to clients and such is that how much IM do you have to post? When we get to we have to come up with a system that's efficient, we have to have strong FCMs, we have to have strong CCPs, we obviously need strong investors, we have to come up and obviously Basel is important. The overall cost you have to -- and I think John alluded to it -- is you have to pay for your risk. We're all kind of like storage units. If you have a lot of furniture you've got to get a bigger storage unit. So if you're bringing in a lot of directional risk you're paying much higher IM. If you're bringing in -- if you're a real value trader doing curve trades and things you're margin is not nearly going to be as high.

But the function -- the real decision, which is the hardest decision, and unfortunately I can't give a step definitive view is if the cost to the market participants, the risk takers or the risk makers, have to be viewed as both the IM plus the capital cost that the FCM or the CCPs have to charge because in the long run if we have -- let's make a bad example -- but if you have two FCMs that are willing to basically pay the guarantee, put a lot of money into the FCM, but they're materially cheaper because they're not charging for it and thus all the buy side is paying is for the IM then you're going to have potentially all of the exposure run to two very cheap FCMs and then you're going to have not mutualized risk; you're going to have two very large ones. So the fact is, while Barclays wants to be very large in the clearing space, and important, we need other dealers - my friends on this side -- to also be very strong FCM and clearing dealers to have a strong contained and protected capital market.

MR. MAGUIRE: Bob --

MR. WASSERMAN: Let me follow up on that point because essentially the point you're making is look, if you're taking part of the capital pullout, namely the potential collateral of fellow customers, you're saying hey, that's going to have to be replaced somehow. And so here's my question. When we're saying that you're going to go from 99 to 99.9, is that tied to an estimate of the amount of collateral or the amount of capital that you would have to meet a default that you'd otherwise use or is it just simply well, we're just going to go up to the next level of magnitude, 99 to 99.9. In other words, are you saying okay, here's how much we have, here's how much we expect from fellow customer collateral; that's going to cost, you know, when we do the Lamfalussy calculation that's going to -- we're going to have so many billion dollars less in collateral available so we have to make that up somehow and basically rejigger the model, or is it just simply okay, 99 to 99.9 because that's the next level of magnitude?

MR. FRANKEL: I think the original model was always to have a 99.9. The defaulter would be paying for their own risk. We split it up so that the mutualization covered some of that, so in my IM I'm paying a certain amount of then my guarantee fund contribution and basically paying the rest so that in total I reach a 99.9 kind of confidence level with mutualization sort of ratcheted so as to cover the model risk that Kim was talking about.

For clients I think the fellow customer risk covered that tail so they, too, had -- not on a pay basis on some potential loss basis -- covered that same sort of tail, so the residual was very, very little, too. So in a sense there was mutualization in the customer book that also effectively it took them to the same level. I think it's not so much 99.9 but it's sort of covering extreme but portable market conditions. That was the notion.

MR. WASSERMAN: If the customer happens to get wind of the FCMs weakness because they're --

MR. FRANKEL: Sure.

MR. WASSERMAN: -- looking at the CNBC and they pull the money out --

MR. FRANKEL: They pull the money out and then the --

MS. TAYLOR: They will pull their money out by taking their exposure.

MR. FRANKEL: Right. So the exposure comes down as clients perceive that an FCM is getting weaker and they pull out their risk.

MR. WASSERMAN: But I guess what I'm saying, and that's --

MR. MAGUIRE: It's the other client defaulting's exposure that you're worried about, not the one that's porting away.

MR. FRANKEL: Right.

MR. MAGUIRE: So that's the fundamental

point here, and that is why we in our public letter said you cannot rely on it. Yes, we said it's zero, and I know everybody will disagree and say it's probably not zero but it's probably not 100 percent, either, but the only thing I can make a conservative and realistic assumption is that it's likely not to be that. And yes, 75 percent of clients went I'm going to take everybody's point. They took their collateral and they took their exposure. But what we're talking about here is the client that didn't take their exposure and they went under. I'm relying on that 75 percent, 80 percent, 90, whatever, to actually close that out. What is that number is the question.

MR. FRANKEL: I think that's right, but I think that a CCP seeing that an FCM is losing all its clients and potentially leaving one rather large one will super-margin that account to make sure that it's now at a 99.9 percentage. The super-margining now taking the place of fellow customer risk. I'm speaking for you, actually.

MR. KAHN: But we're making the

assumption that 75 percent is going to move at that -- at that omnibus that's moved at that level. It's really uncertain how big that client level is going to be. It's a variable. We don't really know how large it's going to be. It's a function of the amount of risk that's been put in the storage unit. So whether it's been moved or we're just not certain how large it's going to be. I mean I know there's been estimates from ISDA, each dealer has estimates and stuff, but it's uncertain how much is going to come from there.

MR. MAGUIRE: Is the safest assumption not for a DCO to say "I can't rely on it" rather than making all these theoretical nebulous sort of predictions of what you may have, the safest thing to John's point about risk, systemic risk reduction, we assume zero, and if there's anything then great, we'll use it, and an omnibus will come. But if it's not that and you don't fight to that end --

MR. FRANKEL: As a clearing member guaranteeing my clients I would definitely prefer that.

MR. WASSERMAN: And so Dan you assume zero.

MR. MAGUIRE: Yes.

MR. WASSERMAN: As the percentage of what might be available.

MR. MAGUIRE: And just to act it out, so therefore margins and guarantee funds would not change from omnibus to LSOC.

MR. WASSERMAN: So Kim, I think you're saying, and Chris you're saying margins would change. So I guess my question would be when you're doing your models, and I don't want to -- I don't want to ask you to give sensitive information out and so I understand that you may need to give a somewhat vague answer, but I guess my question is are you assuming 100 percent or something less of that fellow -- in other words, essentially the diversification effect, are you assuming that that's there to extent of 100 percent or something less?

MS. TAYLOR: I'm not entirely sure I

understand the question. Are you asking me -- when we do our calculations now on what our guarantee should be? Is that what you're asking me?

MR. WASSERMAN: Yeah.

MS. TAYLOR: We do stress testing that is kind of independent scenarios for different sets of products, kind of combine the worst-case losses across the different asset classes, we take into consideration the resources that would legally be available to us to cure that default, and then we look at the gap and we set the mutualization package to more than cover -- well more than cover that gap. But I mean at least at the minimum the best practice standard is to be able to cover the worst-case loss of your worst counterparty in a systemically bad condition.

MR. WASSERMAN: And what I'm asking, though, is you mentioned the resources that are legally available to you.

MS. TAYLOR: And that would --

MR. WASSERMAN: So here's the thing with

the fellow customers.

MS. TAYLOR: That would change. That would change in an LSOC model, and our estimates of what the margin increase would be likely to be are -- if we did it with all margin, you know, you'd have to make a mix decision, are not unlike the estimates that Oliver already talked about.

MR. WASSERMAN: But the question -- forgive me -- the question I'm asking is under the future's model, under the current model --

MS. TAYLOR: Okay.

MR. WASSERMAN: -- you mention that you're going to look at the resources that are legally available to you.

MS. TAYLOR: Mm-hmm.

MR. WASSERMAN: So one that's clear is under the future's model all of the fellow customer collateral that is there on the day of the default is legally available to you.

MS. TAYLOR: Mm-hmm.

MR. WASSERMAN: But in comparing what is there as of the day you do the calculation to what you would expect would be there on the day of default, are you assuming that all of the collateral that's there on the day of calculation, the non-defaulting customers, is going to be available to you on the day of default?

MS. TAYLOR: And I guess here's what I would say about that. We could take a haircut on it; we don't because we would be making an assumption about -- the collateral goes along with the exposure, and so we are making the assumption that we have the right amount of collateral for the exposure that we have at the time under the set of circumstances that we're margining for, and if we do this every day and if there is a change in the amount of collateral we have there is also a change in the amount of exposure that we have, and when we assess whether we've got sufficient resources in our package we take both of those things into consideration. And so we would have to be making assumptions that would be -- you know, they would be guesses, right, on what you were assuming you would lose in terms of the exposure versus in terms of the collateral. They go together.

MR. WASSERMAN: So you're assuming 100 percent of the fellow customer collateral that's there on the day of calculation would be there on the day of default because, as I understand it, you're calculating every day, and so if customers start essentially melting away you'd be changing those calculations.

MS. TAYLOR: Right.

MR. WASSERMAN: Here's my question on that score. So you would be then asking for additional guarantee fund contributions at the same time that you have a member that is essentially on the down-stroke which might correspond to a time when markets are a little bit, well, more volatile than usual. Isn't that procyclical?

MS. TAYLOR: If you -- it could be, but we also look at if the exposure profile changes there are many things that we can do. We can change margins in general, we can change concentration margins in particular, in particular markets, with particular customers, with particular clearing members. We can change the --

MR. WASSERMAN: But wouldn't you then be trying to get money out of the same clearing member?

MS. TAYLOR: We can change the guarantee funds.

MR. WASSERMAN: Wouldn't you be then trying to get money out of the same clearing member which is currently on the down-stroke? I mean in other words, using Lehman as the example, and happily they didn't have a default by a customer, but essentially, so during that week 75 percent of the customers who were there were of course going to other -- other FCMs. Assume contrary to what -- the experience that they had some customers and some big customers who didn't who happened to be the ones who were defaulting --

MS. TAYLOR: Right.

MR. WASSERMAN: Your ability to get additional collateral out of Lehman, do you think that --

MS. TAYLOR: Well, that is a good question and that is why we did not just sit on our hands the week of Lehman and we made sure that we were helping to find solutions for people to move their positions. The very best outcome in any of these situations is for customers to be able to exit the failing clearing member before there is a problem. We very actively do that. We actively solicit on an ongoing basis a set of what we call white knight firms who stand ready to look at situations where we might need them to take kind of a bulk transfer of clients. We have a stable of people that have offered to look at a portfolio if we ever need bidders. We have a stable of White Knight potential bidders who will look at a portfolio if we needed to sell one on short notice. We actually liquidated the Lehman house portfolio in basically five hours because we found out very late one night that they were -- it was not going to be part of the bankruptcy transaction, the purchase, and by 8:00 the next morning we sold the entire book, and people got the portfolio information at like, I don't know, 2:00 in the morning. So it was -- we're able to marshal the resources and the capacity to risk manage situations as they're occurring very readily and very actively. If we just sat on our hands you would be asking me some really good questions.

MR. MAGUIRE: Could I just maybe ask a question of the FCMs? If there's been a default of an FCM on the clients, and there are a bunch of clients who wish to pull from the defaulting FCM, or just prior to it going to default to yourselves, are you more likely to accept that port on a 99.9 percent confidence interval or on a 99 percent confidence interval where they're paying for the margin themselves? Because if you take the 99 you're going to be paying a higher guarantee fund which will also have capital charges under Basle III. So what would the FCM do in terms of giving a higher probability of portability? Which approach would be preferable?

MR. FRANKEL: The 99.9.

MR. MAGUIRE: I rest my case.

MR. FRANKEL: I mean you're asking us to guarantee risk in an extreme conditions and we would like margin to cover that. Whether it was the minimum or not we would want it.

MR. DIPLAS: But then in general, I mean you take the portfolio at the level that you do an evaluation if there's adequate margin coming along with it.

MR. KAHN: But we made the assumption at the beginning of this panel after lunch that these products, the OTC derivative products, had more price volatility. That's an assumption in futures, and it's great that it kind of flowed smoothly in futures. At the same time that Lehman was melting and this stuff was happening behind the scenes the bid for various OTC derivative products, particularly in credit, was not very good. Okay. In fact it was almost nonexistent. Or it was one by one for a single-name CDS. So the fact is I'm not convinced that the ease of finding the white knight on OTC derivative portfolios will be as easy as it has been.

MR. MAGUIRE: Agreed. I understand they said probability, so I'm just saying the probability would be higher that you take something with a higher confidence interval, but you know, you can't guarantee that.

MR. PRAGER: But I think that's an excellent point that you're making, Ray, because I think when you started off today, Bob, by drawing these parallels so we can just make sure we're having apples-to-apples conversations, and Kim, I have no doubt that you will handle the Lehman situation fabulously, but I do think that with just not comparing it to what the cleared swap portfolio will look like it's going to be a much different risk profile. Not just priced volatily, Ray, but this liquidity situation that I think we talked about. Someone drew out that distinction before. So I think we have to go back to what did LCH experience, how did that happen, over what time period because that was real. And that's the type of portfolios we're talking about.

So I do think if you string together some of the comments that John made about the subsidization that we see in the future's model, and then maybe that's acceptable with these, you know, the type of products we're talking about which have smaller volumes and less liquidity issues than swaps, that's -- maybe that's acceptable, but I do think we have to look to where we've seen the precedent with LCH in an LSOC environment with the higher IM, with assuming that there'll be no client buffer there and if you have to pay for the risk you should.

The only other point I'd add to that is that higher IM has another effect, which is its incentive for clients like ourselves and others to keep tidier books. So if you want to get that IM back you just go and do more tear-ups and you actively manage line items so you're not consuming all of that initial margin out there so it has actually a very positive ancillary effect to managing risk, and it's good for the system.

MR. WASSERMAN: So Richard, I just want to make sure I'm understanding. What I think I hear you saying is that while in Lehman there was a, you know, that five-hour, you know, the liquidation and the ability to sell the portfolio, your concern is that there is a higher probability in the swaps world that there may be portions of a portfolio that will not transfer anywhere near as readily. You got to speak into the mic.

MR. PRAGER: I agree. Yes.

MR. MAGUIRE: Maybe to give some color of how the Lehman close-out happened for the interest rates. I was there, I was involved, and we had a holding period. In the first instance you take the 66,650 trays or whatever it was, nine trillion, etcetera -- I won't bore you with the detail -- but we break that down into risk, trading risk into delta pillars. We traded -- we executed in the region of 100, 150 large hedge trays across multi-currencies, and that micro-hedged the portfolio probably within the first two or three days, and then we didn't -- using Kim's phrase, we didn't just sit on a hunch. You have to keep micro-hedging, dynamically hedging the portfolio, the portfolio of interest rates or credit derivative swaps is a living organism. It changes shapes and moves by the second, so you have to keep micro or dynamically hedging that.

But once we got to a point of low volatility in the portfolio so minimal variation margin volatility in the portfolio, we then enter into the next phase which is an auction. I think it's really important. We actually executed real trades. We didn't auction live risk. We hedged the portfolio within a degree of tolerance then we broke that up into chunks and we gave that back out to the non-defaulting clearing members for them to take the portfolio in, or for the tens of thousands of trades, revalue the portfolio against their own curves, calculate the risk, any novel positions in the curve risk, reset risk, etcetera, and then they made a bid on it, and then we took -- we accepted bids. But this was over the course of a two, three week period.

So yes, in the first two or three days we'd hedged the risk, but we still have this living organism, for want of a better phrase, over a two, three-week period whilst we auctioned the positions off and transferred them to the non-defaulting members. To give you some context, that was all within -- we give back about I think it's within 40 percent of the initial margin, so we gave back about half of the initial margin back to Lehman Brothers Estates, so the end result was there was nobody impacted. None of the clearing members were impacted by that, or any of the clients.

MS. AYOTTE-BRENNAN: Well, I think it's also important to Richie's point is that -- and to Ray's point -- that the porting of these books could be much different because today our swaps are done out of a different entity than the FCM with our dealers. Now you're going to have those transactions all done with the FCM. A client may reach its exposure with an FCM much quicker now on those trades because now you have futures and swaps that may need to be ported, and it may not be able to go to just one FCM if that FCM doesn't want to take on the exposure to fidelity at that level because it already has swapped some futures with us. So we may reach our credit levels much quicker with an FCM and have to port to more FCMs than we did in the Lehman situation.

MR. KAHN: So that point we will have limits, portfolio limits, for all of our clients. You're likely to have your margins potentially going up at that period and more payments, so you know, the question is can you take it all in. And you have the operational issues of -- as I stated earlier, operationally if there's large hundreds or thousands of line portfolios that need to move, do the FCMs, do the CCPs have the manpower to basically move thousands of line items in a one, two, three-day period. I can't tell you all the people -- I'd love to be able to tell you that Barclays can handle every line item of the clients represented over there, but if it's a stress situation I don't know that we can do that on a one or two day period.

MR. WASSERMAN: Well, you guys have the most experience with that now.

MR. KAHN: We're doing the best we can. I mean we're all trying to build straight through processing, but let's be honest with reality. I mean taking in -- to the point of my fellow FCM colleagues, we'd love to look at the portfolio and say this is a portfolio we like, it's short, it's long, all this type of stuff, but if you have a thousand line item portfolio you've got to bring that in and also process it operationally. There's a lot of stuff going on.

MR. DIPLAS: No, but that's why I think clients probably want a lot of options as to where they're going to go. Probably pre-default portability is the answer. Post- default I think is going to get a lot more complicated.

MR. WASSERMAN: Speaking of options, actually what I'd like to do, and at the risk of complicating this yet further I want to bring back our discussion of optional models here because I guess my -- you know, we were talking about going from 99 to 99.9 and/or some increase in guarantee fund.

So let's say instead we do an optional model, and let's say folks representing 50 percent, 60 percent of a book decide to take that optional model. So it seems to me there are two questions. What would be the impact -- we already spoke about operational costs and what would be involved there and what folks were already incurring, so let's for the moment put those operational costs off to the side, simplify this a little bit. Risk costs, how would you impose the additional risk costs on the people who are taking the option to have greater protection and what would be the impact of risk costs on those folks who don't to the extent that having the people who are looking for the greater protection, their diversification is now walking off the scene and so you may have whatever is left in my hypothetical 40 or 50 percent of the book, which is less diversified because these guys who probably will tell us that they tend to be the less risky of the customer base, they're walking off, so what are the impact I guess risk costs on them and what's the impact risk costs on the rest of the book if we were going to say an outside model?

MR. MAGUIRE: Fundamentally we don't believe that that client mutualization there will be that. Now we know it's probably not zero, but we made that assumption, so just to be crisp on this, the margins would be the same and the guarantee fund would be the same. We made no distinction.

MR. KAHN: But Dan, you guys offer an option, right?

MR. MAGUIRE: We offer options, but the margin is the same under each option because we don't rely on any client mutualization under any of those.

MR. KAHN: But would you expect when the many clients, thousands of clients, come into the space, which one do you think they'll choose?

MR. MAGUIRE: The one with better protection for the same price.

MR. PRAGER: From -- yeah, from our perspective that's the answer.

MR. DIPLAS: But if it's the same price why would anybody take anything less --

MR. FRANKEL: Let me try and also -- it seems if the quality of a fellow customer risk, that mutualization shrinks, then the DCO, the CCP will have to increase the margin levels from 99 to 99.3, 4, whatever it is to make up to the same level of security for the DCO, which just means that at more risk with more money and it's looking less and less attractive. I don't know why everybody wouldn't move now to the legal seg model, and I don't see the value of offering the optionality in that case. I think that there would have to be a migration. I think it would just be a natural economic affair. Everyone would migrate to the legal seg model.

MS. TAYLOR: Well, but there's the --

MR. FRANKEL: I mean it's hypothetical.

MS. TAYLOR: At a risk cost basis if it got to the same place then I would agree, people would tend to choose the greater protection for the same price, but there's also the operational costs, and I don't know if those outweigh it for people.

MR. DIPLAS: Kim, could you do it -- you couldn't do it even at a different price. If you have five clients, four of them get 99.9, the fifth one gets 99, well, who is going to pay for that difference?

MR. KAHN: Yeah, but the biggest cost is, as we said here, is the movement in IM going from 99 to 99.7. There's no way the operational costs are going to come anywhere near that --

MR. PRAGER: As we said, there is none.

MR. FRANKEL: I think, talking for Kim --

MS. TAYLOR: Not everybody --

MR. FRANKEL: I think Kim's --

MR. WASSERMAN: And just to be clear, what I'm saying is analytically I'm not sure that the operational cost is changing it. I guess what I'm trying to get at and trying to -- but again, tell me if I'm going down a bad path here -- is that if -- the thought earlier was, and I think there's this general thought, let's offer options; those who want better protection pay more, those who don't want to pay more get lesser protection. And I guess what I'm asking is as a practical matter and as a logical and economical matter, because of the risk cost issues, because I think -- and tell me if I'm wrong -- risk cost depends upon diversification if you're taking -- if some customers, if some large portion of -- not the number of customers but the weight of the customers, the weight of the margin, if you will, goes off and is protected individually, then are the folks who choose, who want to opt not to pay more really going to be paying less because I think the risk costs then would be permeating throughout the account. But please somebody tell me where I'm going wrong.

MR. FRANKEL: I cannot. But I think Kim

was referring to the option between the future's model and the full seg model as opposed to the complete seg model, and I was referring to the option between the future's model and the complete seg model, the LSOC.

MS. TAYLOR: Which one is -- okay. LSOC.

MR. FRANKEL: LSOC. So I think we just more or less agreed. But that's why the operational cost, because he was referring to the full seg.

MR. WINTER: If I can, I may be missing something here, but if the margin is commensurate with the risk of a client's portfolio and a client opts to move into one seg pool versus another, what remains doesn't change in terms of the existing pool that's losing it because if it's got a lot of risk it's taking a lot of collateral. If it's got low risk it's taking low collateral. So I don't think it's going to overly impact that. And as far as the cost, I mean that's a dollar and cents cost for moving it into an option where you can get that better protection. So I'm afraid we might be combining two separate issues here, and one is the cost of having that optionality in terms of pure dollars and cents versus margin to protect each client or every FCM and therefore every participant to make sure that the client is properly margined.

MR. WASSERMAN: But your assumption here, and this is -- the assumption you're making is that each client is providing sufficient collateral for his or her individual position, and as I understand it in the future's model each customer's position is guaranteed partly by that customer, partly by the capital of the FCM, and -- say it quietly -- partly by the fellow customer collateral of that FCM in the event that there is a default by the FCM. And so if that --

MR. MAGUIRE: Caused by another customer.

MR. WASSERMAN: I'm --

MR. MAGUIRE: Caused -- if the FCM's default was caused by another customer.

MR. WASSERMAN: Yes. An FCM. Absolutely. But the point is to the extent you're relying on fellow customer collateral, then essentially part of what's meeting it, that's where the change is, part of it is the fellow customer collateral. If you're not relying on it then there's absolutely no cost and that's Dan's position.

MR. FRANKEL: I think Steven's point is right if you're charging 99.9 in one account and 99.9 in the other. If you charge at different confidence intervals that's when you get the situation you talk about.

MR. THUM: Bob, I think you hit the nail on the head, and I think running from the LCH approach which has zero effect to the fellow customer risk, I think what Oliver was saying made a lot of sense, that as that diversification component exits the future's model the margin level will have to go up from 90 -- from 99 percent up to 93, 94, 95, and as that increases those people will jump out of that bucket into the

LSOC bucket because they really will not be saving anything and be taking on considerable risk.

MR. COX: But why is there equilibrium when they've all moved? I mean couldn't there be some point where it goes from 99 to 99.2 and at that point then I, okay, well I'm paying a bit more than I was but it's still better than 99.9 so I'm going to stay put.

MS. TAYLOR: It absolutely could do that. It all depends on what happens to the exposure profile of the -- of the pool.

MR. DIPLAS: But the thing is it's going to be very difficult to have these two -- to have clients that are margined at different confidence intervals coexist in the same pool. I think it's going to be very difficult. If you can take it to the extreme cases that there's only one client left that's margined at a different level, you're going to have a deficit. You're going to need to have the same confidence interval for the whole account. Either these funds are there or these funds are not there. I think it's going to be very difficult to have this hybrid that some people choose to pay a little bit more and some will not because you don't know what ratio, what mix you're going to have with clients.

MR. COX: Don't you FCMs do that anyway? I mean it sounds like already you should all be margining your customers to 99.9 because you don't get the benefit of cross- customer risk, right? One of your customers defaults you don't go --

MR. DIPLAS: No. It's the CCP level. It's the CCP level that I'm saying they wouldn't want to have the certainty that when we go under as a result of a client default.

MR. COX: Right.

MR. DIPLAS: There is going to be a guarantee effectively that there is going to be enough money there. But that's a bonus. But if at the end the only people that are left there are actually -- is one client that was margined in 99, you just have a one dollar deficit.

MR. COX: Right.

MR. DIPLAS: What do you do at that

point?

MS. TAYLOR: But Athanassios, if you got there the CCP would be taking some action because there is no diversification in that pool. So --

MR. COX: Practically thinking, do you guys really do that, the CCPs? I mean how many of your FCMs are you super-margining at the moment?

MS. TAYLOR: How many FCMs are on super- margining at the moment? Maybe like 15.

MR. DIPLAS: When you say you're taking action you're basically moving from kind of this formulaic opposed to ahead to something, but you're moving from 99 to 99.9 effectively. You're moving that plan up. That's what you're effectively doing by taking action. You're taking -- you're charging higher margin at that point.

MR. EDMONDS: And I certainly think the use of concentration margins, Rupert, you would -- those exist and those are active today, and we collect those, given the position that we hold for that individual. So they're active and I would, you know, roughly say the percentage of members that are paying that at the moment inside of ICE Trust is probably close to the percentage that Kim just gave you inside of CME.

MR. WASSERMAN: And just now may be a good time to mention we had put in the rule, I think it was 22.13, some specific provisions noting that DCOs -- we wanted to make sure that it was clear that you had certain tools that -- and that may have been belt and suspenders -- that you could require individual FCMs to collect additional collateral from individual customers or individual FCMs to put up additional collateral from their own funds that would be free for you to use. I don't know -- I hope that's --

MS. TAYLOR: We already have rules that allow us to do that.

MR. WASSERMAN: And so that is a helpful tool. Yeah, then I'm not surprised that you already can. That is a helpful tool for addressing this so that there is a closer tie between who is in fact imposing the risk and who in fact is paying for the risk. Is that -- I mean does that help at all?

MR. EDMONDS: I think you're codifying in the regulations what's already in our individual rule books today, so you know, from the standpoint that there's no path to escape I would say that that is helpful from that perspective.

MR. WASSERMAN: And just to be clear that essentially to the extent you do that on an individual customer basis there would be greater than -- there would be greater margin that's accessible to you even under LSOC, and likewise to the extent that you collect the money from the firm, again that is additional collateral that's available to you under LSOC. Not -- in other words, not just simply under your current rules but even with LSOC you'd be able to get additional pinpointed protection, if you will. Pinpointed collateral.

MR. EDMONDS: As it relates to a granular position, yes. Bob, are you at all concerned about, you know, we talked a lot today about portability and making the ease of portability and I don't think anyone disagrees with that because it is an effective tool especially as mentioned earlier on a pre-default basis, you know, to make sure we're -- we understand Ray's analogy, what we're putting in that cup and what we're going to manage in those points in time -- if we look at that from a more holistic perspective as -- and I don't want to spend time getting into membership requirements and the rules that you've contemplated there, but as it relates to that, one thing that the fellow customer risk does introduce is it does make it incumbent, and I appreciate Richie's point and others that have made the point where they don't have the tools set to see exactly what their FCMs have in their book, and certainly there are a number of us that spend a lot of time talking about what unencumbered capital may look like and if we could ever get to a world where that type of information become more public and things of that nature, but nonetheless, the fellow customer risk, there is an obligation that there has got to at least be some recognition and concern that could dissipate. Not necessarily from the sophisticated folks in this room, but they don't represent exactly all of the buy side that we have to deal with or all that would take some interesting position, to make certain they understand who they're doing business with. If you protect them, if the protection is all the way around and we don't care are we inviting more of that? Have you thought about that as we went through the creation of that?

MR. WASSERMAN: And the answer is yes, and I guess I would have a couple of responses there. First, as Jim will point out, has pointed out to me and I imagine will continue pointing out to me, the protection we're dealing with, that we're creating with LSOC, is not perfect. There are -- he's pointed out a number of ways in which it falls short of perfect.

MR. EDMONDS: That's the only agreement we've had in the room today.

MR. WASSERMAN: I'm sorry?

MR. EDMONDS: That's the only agreement we've had in the room today.

MR. WASSERMAN: And so we've -- you know, again at least from where I was coming from I intended to design it on -- with a lot of consideration of cost and benefits and aiming to achieve the greatest level of benefit at the least level of cost, but in doing that you end up at least sacrificing some benefits and achieve less than perfection, one.

Two, even if we had achieved perfect, you know, something perfect, I don't think anybody on this side of the room or anybody in that kind of position would enjoy the kind of roller coaster ride that is simply guaranteed if your FCM happens to become insolvent. Indeed, as I've said repeatedly, I am not prohibiting you from liquidating all the customer positions that a FCM the moment they become out of good standing because again that, you know, from where I'm sitting, has to be your right.

So again, these -- in short what I'm saying is, am I changing the level of exposure the folks on the buy side have? Yes. Am I removing their incentive for doing at least some degree of due diligence to make sure that the firms they deal with are not going to go insolvent? Heck no. I rather think they are going to continue to have those incentives to avoid -- you know, there was a definite residual both in terms of risk and in terms of just simply -- I don't think their clients are going to be happy with them if they -- if they're dealing with a defaulting FCM regardless of how well they end up getting protected. I imagine there's going to be some reputational risk there. Again, when you add that to the fact that as we've discussed for them to do anything, you know, anything more than a cursory due diligence, a real deep due diligence where you can say well gosh, there's a connection between their incentives and therefore they're going to exert market discipline because they're going to do effective risk management of their clearing member, I don't think that's possible.

I think for reasons we've discussed that the clearinghouses are structurally in a far better position to do it because they get better information, because they have concentration of expertise, because they're already doing it and already have to be doing it in their role as clearinghouses, so to have these guys each create a department of people who would have the capabilities -- you know, even if they could get the information, which they can't, to have them create a department of people who have the capability and the expertise that your people have, the people you're already employing, would be imposing a lot greater cost for I think very, very little benefit.

MR. HARSHAW: I know our time is coming close. I want to just make a couple points. First off, I want to thank you for the great movement from a nothing in any proposal to a very significant movement and your team, Laura, as well, and we're grateful for that. We view this as a significant first step, and there is -- the market is going to have to undergo a significant cost. There will be winners. The DCOs are clearly big winners. But one of the things that we would say is that if you can't get us the protections that we have today for political, for cost, for whatever reasons there are, that the Commission has made some policy decisions. For example, we get to choose where we clear. We get some choices. And we would argue, at least for our pension plans, you know, we paid billions of dollars out of benefits every year and we want to keep being able to do that. We had protections during the Lehman crisis and the credit crisis that served us well. We would ask that if it will take time, if it will take cost, if it will take political movement in order to get us to full seg what we have today, that we adopt the policy that the European regulators seem to be going to, which is to exempt pension plans from having to clear until those costs, operational issues and political ones, are resolved so that we don't put the common man and common woman at risk because that's exactly what Dodd Frank was drafted for, to protect the common man and the common woman. And what we're saying here is that we -- we acknowledge that all of these issues are legitimate ones and thorny ones -- exempt us from clearing until they're worked out.

MR. NICHOLAS: Yeah. If I could just get back maybe to Bob's point, I'm not -- I don't think that it would be a case where the buy side would stop doing due diligence on FCMs, but I mean I do think that it would become less of a factor in -- I mean there's a number of factors why they choose FCMs. There's cost, there's a whole bunch of things. But I can't believe it would become less of a concern if they knew that at the end of the day their positions are guaranteed.

MR. PRAGER: I'm sorry, you're saying it would be less of a concern?

MR. NICHOLAS: No. I'm saying it would be -- I would think it would be less of a concern for customers.

MS. AYOTTE-BRENNAN: That won't happen. I mean we're fiduciaries and we have a fiduciary responsibility to do this analysis, and we will not stop doing it regardless of what model is chosen. We care about the creditworthiness of our FCM and we care about that due diligence. And as a fiduciary if we didn't we wouldn't be doing our job.

MR. NICHOLAS: I hope that's true.

MR. PRAGER: I agree.

MR. NICHOLAS: And for the folks in this room I'm sure it is, but I'm not so sure that that would be true of all customers. The other thing, just real quickly before we go, one of the points that you -- that is raised in the release as to why the staff selected this particular -- or prefers this particular model -- is portfolio margining. And it seems to me that introducing another potential -- you know, having the future's model, the legal seg, complete legal seg model, and then a securities model, you're just complicating -- maybe I'm not understanding it, but it seems to me you're complicating portfolio margining rather than --

MR. WASSERMAN: Actually no because here's the deal. Under an omnibus model, whenever you're bringing something from outside the pool into the pool you're putting a risk not only for the folks who are trading and are getting the benefit of the portfolio margining for their mixed positions, but you're also exposing to the same -- to that risk -- all the other customers because again, remember there's essentially a socialization of the risk.

Under an individual customer protection model each customer bears their own risk and the other customers are being, if not perfectly, substantially insulated from that risk. And so if I'm bringing in an additional risk that I bear but Laura does not then the regulator has less of a concern than if I'm bringing in a risk that I'm also sharing with Laura because again individualized risk means less concern over portfolio margining.

MR. RADHAKRISHNAN: Okay. I'd like to thank everybody for their contributions. I know extremely weighty topics, particularly for discussion on a Friday, but I am very grateful for everybody's contributions. I would encourage not just everybody here but all of those who are interested in this topic to please write to us. As Bob has pointed out, the document has not made it yet to the federal register. Is that correct? Hopefully it --

MR. WASSERMAN: Federal register has not yet seen fit to publish the document. It made it to them many, many weeks ago.

MR. RADHAKRISHNAN: Okay. So they've not seen fit to publish the document. And how many days did we give people to comment?

MR. WASSERMAN: Sixty days from when it does.

MR. RADHAKRISHNAN: Sixty days. But you've had the advantage of looking at it these past six weeks because it's on our website, so -- and I don't think we're going to change, there's not going to be any changes in the document.

MR. WASSERMAN: No. There are changes in formatting that are completely non-substantive.

MR. RADHAKRISHNAN: So please, you know, you guys have all made very important points and a lot of things for us to think about in your points. I was just waiting for the point that Jim made to be made, which is -- and I know that EMIR has said -- has basically exempted pension funds, is it three years or something to that effect, so I was waiting for that point to be made. I'm glad you made it. Otherwise I'd be very disappointed if nobody had made that point. So thank you again for your valuable contribution, and enjoy your weekend. Thank you.

(Whereupon, at 4:46 p.m., the PROCEEDINGS were adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

DISTRICT OF COLUMBIA

I, Irene Gray, notary public in and for the District of Columbia, do hereby certify that the forgoing PROCEEDING was duly recorded and thereafter reduced to print under my direction; that the witnesses were sworn to tell the truth under penalty of perjury; that said transcript is a true record of the testimony given by witnesses; that I am neither counsel for, related to, nor employed by any of the parties to the action in which this proceeding was called; and, furthermore, that I am not a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Notary Public, in and for the District of Columbia

My Commission Expires: April 30, 2016