S. HRG. 112–288

EMERGENCE OF SWAP EXECUTION FACILITIES: A PROGRESS REPORT

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

A PROGRESS REPORT ON THE EMERGENCE OF SWAP EXECUTION FACILITIES

JUNE 29, 2011

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

73–132 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
DANIEL K. AKAKA, Hawaii
SHERROD BROWN, Ohio
JON TESTER, Montana
HERB KOHL, Wisconsin
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
MICHAEL F. BENNET, Colorado
KAY HAGAN, North Carolina

RICHARD C. SHELBY, Alabama
MIKE CRAPO, Idaho
BOB CORKER, Tennessee
JIM DEMINT, South Carolina
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
JERRY MORAN, Kansas
ROGER F. WICKER, Mississippi

DWIGHT FETTIG, *Staff Director*
WILLIAM D. DUHNKE, *Republican Staff Director*

DAWN RATLIFF, *Chief Clerk*
WILLIAM FIELDS, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

JACK REED, Rhode Island, *Chairman*
MIKE CRAPO, Idaho, *Ranking Republican Member*

CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
DANIEL K. AKAKA, Hawaii
HERB KOHL, Wisconsin
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
MICHAEL F. BENNET, Colorado
KAY HAGAN, North Carolina
TIM JOHNSON, South Dakota

PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
BOB CORKER, Tennessee
JIM DEMINT, South Carolina
DAVID VITTER, Louisiana
JERRY MORAN, Kansas
ROGER F. WICKER, Mississippi

KARA STEIN, *Subcommittee Staff Director*
GREGG RICHARD, *Republican Subcommittee Staff Director*

C O N T E N T S

WEDNESDAY, JUNE 29, 2011

WITNESSES

Additional Material Supplied for the Record

EMERGENCE OF SWAP EXECUTION FACILITIES: A PROGRESS REPORT

WEDNESDAY, JUNE 29, 2011

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:32 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call this hearing to order. Senator Crapo and I want to welcome our witnesses. This morning we are going to focus on the topic "Emergence of Swap Execution Facilities: A Progress Report."

The financial crisis revealed some significant weaknesses in our financial sector. One of the most problematic was the over-the-counter derivatives market. As a result, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 developed new rules for the OTC market to insulate both the U.S. economy and the American taxpayer from any future extraordinary losses in this area.

In particular, Dodd-Frank mandated that all cleared trades be executed either on an exchange or on a new trading platform called a swap execution facility, or SEF. The Dodd-Frank Act defined a swap execution facility as "a facility, trading system, or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system through any means of interstate commerce."

The development of SEFs should transform the current trading marketplace by providing significantly greater pre- and post-trade transparency for regulators and market participants alike.

In addition, once a trade has been completed, a counterparty should be able to compare the price it receives on a particular trade with the price of similar trades that buy and force similarly standardized products. This information should also be useful to those analyzing the effectiveness of hedging strategies. Finally, increased transparency in the new trade reporting requirements will give regulators better information and additional tools to monitor the swaps market for possible market manipulation.

The Commodity Futures Trading Commission and the Securities and Exchange Commission have both proposed rules to implement the SEF provisions of the Dodd-Frank Act for swaps or security-based swaps under their respective jurisdictions.

In addition, because standardized swaps that are cleared must be traded on an exchange or a SEF, Dodd-Frank Act requires clearinghouses to provide open access to various execution venues. Both the SEC and CFTC have proposed rules that implement the open access requirements of the Dodd-Frank Act to encourage competition in the SEF and clearinghouse market.

All of us have a vested interest in making sure these new derivatives swap execution facilities function safely, efficiently, and fairly. Hopefully, our hearing this morning will help us understand best how we can accomplish this objective.

Senator Crapo and I have invited witnesses that represent a variety of opinions and perspectives to our hearing. Unfortunately, due to scheduling difficulties, the large dealer bank we invited was unable to appear before the Subcommittee today. Nonetheless, we hope the conversations we have this morning spur deeper thought on these complicated issues, and we encourage participation by written testimony or comments after the fact, and that both industry and policy makers continue to work together to make our swaps markets the most transparent, competitive, and efficient in the world.

I look forward to hearing from our witnesses, and at this time I would like to recognize the Ranking Member, Senator Crapo. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Senator Reed, and I appreciate the opportunity we have to work together on this Committee and also the fact that you have noticed this hearing with regard to SEFs.

There are a number of different electronic trading models that could be potentially used for derivatives trading depending on the final rules the SEC and the CFTC and international regulators adopt. But I want to focus just on a couple of concerns that I see us facing right now in our current posture.

While Title VII of the Dodd-Frank Act states that the SEC and the Commodity Futures Trading Commission shall consult and coordinate to the extent possible for the purpose of assuring regulatory consistency and compatibility, it appears that the lawyers for the two agencies, or maybe the other personnel at the agencies as well, have not been able to agree on what these terms mean.

We should not then be surprised that the two agencies have proposed inconsistent approaches to the same rule sets. For the swap execution facility rules, the SEC approach, in my opinion, is a more principles-based approach and is in general far less prescriptive than that of the CFTC. While the Dodd-Frank Act missed a great opportunity, in my opinion, to merge the SEC and Commodity Futures Trading Commission and stop the bifurcation of futures and securities markets—we lost that opportunity then—we should at least continue to push for more coordination and consistent rules.

Swap execution facilities are likely to dually register with both agencies, and it makes a lot of sense for the two regimes to be consistent.

While I applaud the SEC for taking a more flexible approach relative to the CFTC, both agencies need to make their rules more accommodative of the different types of SEFs to provide the maximum choice in trade execution to market participants.

Under the current CFTC SEF version, the proposed rule requires swap users to request prices from no fewer than five dealers at a time. This is generating a lot of controversy from the end user community, which argues that it may ultimately serve to unnecessarily disadvantage end users by limiting their ability to chose appropriate numbers of counterparties and the mode of execution in the way that they deem to be the most efficient and effective to hedge their commercial risk.

Since Dodd-Frank stipulates that the transactions required to be cleared must also be evaluated on a SEF or designated contract market, there is significant interplay between the clearing, trading, and definition of block trades. According to the end users, this could create a problem for some less liquid trades that would be suitable for clearing but not necessarily for trade execution.

I have also been advised that the SEC's SEF approach is more consistent with what the Europeans are looking at, but I have not actually seen the exact comparison.

If we want to find a common international framework in order to avoid regulatory arbitrage and avoid competitive disadvantage to our markets, we need to provide greater coordination and harmonization to get the rules right rather than rushing them through.

This is just a short summary of some of the issues that I am concerned about that I think we ought to focus on in today's hearing. I also welcome today's witnesses, and I look forward to what we will hear.

Chairman REED. Well, thank you very much, Senator Crapo. And before I ask Senator Corker if he has comments, let me associate myself with your comments about collaboration, the joint regulation between the SEC and CFTC. I hope one of the results of this hearing is to be able to focus their attention on coming up with a consistent rule for both agencies rather than two distinct sets of rules. I think that is going to—the intent clearly, as you point out, in Dodd-Frank was to have one set of consistent, appropriate, flexible rules. And I, again, second your very insightful comments in that regard.

Senator Corker, do you have any comments?

Senator CORKER. Thank you, Mr. Chairman. I am looking forward, as usual, to the testimony, and I appreciate you having the hearing.

Chairman REED. Thank you very much.

Let me introduce the first panel. Our first with is Mr. Kevin McPartland. He is a principal and director of fixed income research at TABB Group. Mr. McPartland joined the TABB Group as a senior research manager in 2007 from a management consultancy, Detica, where he was a senior manager in the Global Financial Markets Division. Prior to joining Detica, he held positions at JPMorgan Chase in equities and futures and options, managing development, and implementation of electronic trading systems. Thank you.

Our next witness is Mr. Neal Brady. He is the chief executive officer of Eris Exchange. Prior to cofounding Eris Exchange and assuming the role of CEO, Mr. Brady served as managing director of business development at CME Group, where he was responsible for the growth of the CME Group's OTC and global business. Prior to CME, he founded and served as chief executive officer of Liquidity Direct Technology, a leading platform for interest rate derivatives trading that was acquired by CME in January 2004.

Our next witness is Mr. Ben Macdonald. He is a naturalized U.S. citizen residing in New York City. Thank you for that, Mr. Macdonald. He is the global head of fixed income products for Bloomberg, L.P., a position he has held since May 2010, and in that capacity he heads up Bloomberg's Swap Execution Facility Development Initiative. Prior to joining Bloomberg, he worked at Goldman Sachs managing the credit default swap operations team and at JPMorgan Chase where he held several positions in interest rates derivatives.

Our final member of the panel is Mr. James Cawley. Mr. Cawley is the chief executive officer of Javelin Capital Markets, an electronic execution venue for credit derivatives and interest rate swaps. Javelin expects to register as a swaps execution facility. He is also the founder of the Swaps and Derivatives Market Association, an industry trade group of several dealer and clearing brokers that advocates for successful OTC derivatives clearing, open access, and transparency. Mr. Cawley has 20 years of derivatives sales and trading experience, working for many years in the credit markets for Salomon Brothers, Lehman Brothers, and Bank of America. Most recently, Mr. Cawley ran IDX Capital, a credit derivatives interdealer broker.

I thank you all for being here this morning. Senator Merkley, do you have any opening comments?

Senator MERKLEY. No.

Chairman REED. Thank you. I would ask the witnesses to limit their remarks to 5 minutes. Your written statements will be completely incorporated into the record, so there is no need to read them.

Mr. McPartland, if you would begin, please. Thank you..

STATEMENT OF KEVIN McPARTLAND, DIRECTOR OF FIXED INCOME RESEARCH, TABB GROUP

Mr. MCPARTLAND. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for inviting me here today to discuss progress and concerns surrounding the creation of swap execution facilities.

I am Kevin McPartland, a principal and the director of fixed income research at TABB Group. TABB Group is a strategic research and advisory firm focused exclusively on the institutional capital markets. Our clients span the entire investment landscape including investment banks, pension plans, mutual funds, hedge funds, high frequency traders, FCMs, exchanges, and clearinghouses.

In order for this new market structure to be successful, swap execution facilities must be given broad latitude in defining and implementing their business models. This includes, but is not limited to, the mechanisms used for trading and the risk profiles of their members. This will promote the innovation and competition that has made the U.S. capital markets the envy of the world.

It is also critical that the mechanisms to move trades quickly and easily from execution to clearing are well defined. If market participants worry that the trade they have just executed on a SEF might later in the day be canceled due to a clearinghouse rejection, confidence in the entire market model will erode quickly and severely limit the transparency and systemic risk reduction the Dodd-Frank Act was intended to improve.

Let us examine these points in detail.

First, SEFs should not be driven to a particular trading model. Despite the inclusion of the Request for Quote model in proposals from the CFTC and SEC, regulators are still keen to have swaps trade through an order book with continuous two-sided quotes.

TABB Group research shows that order book trading will emerge naturally; 81 percent of our study participants believe that we will have continuous order book trading of vanilla interest rate swaps within 2 years of SEF rule implementation. However, the existence of an electronic order book does not guarantee liquidity nor that market participants will trade there.

For example, of the roughly 300,000 contracts available for trading in the highly electronic U.S. equity options market, trading in only the top 100 names makes up nearly 70 percent of the volume. The rest are seen as so illiquid that it is often easier to trade OTC with a broker rather than try and execute that same contract on the screen. Furthermore, despite the market's electronic nature, TABB Group research shows that in 2010 as much as 97 percent of all options trading volume generated by asset managers was done over the phone.

Second, we should encourage SEFs to set membership requirements to encourage a variety of liquidity pools. The U.S. equity market presents a good example. Thirteen registered exchanges and another 55 alternative execution venues exist to trade U.S. equities for a total of sixty-eight. Why are there so many? Because different market participants trade in different ways and have different needs. Some like to trade in large size, some small; some are very concerned about price while others are more concerned about getting a trade done quickly. Because of this, the equity market responded with new venues to meet those needs.

In the current swaps market, a smaller player cannot trade in the interdealer market even if they had the capital and desire. In the new market, as long as a trading firm meets the requirements set forth by the SEF, they will be—and should be—allowed in to trade. The important point to note is that setting membership requirements for SEFs is not exclusionary, but instead intended to help market participants trade in the most suitable environment possible.

Open access to clearing will play a huge role in the success or failure of all SEFs. It is central clearing, not the SEF construct itself, that will allow easier access to trading and new market participants to enter. But a clearinghouse providing only the ability to accept SEF executed trades is not enough.

SEFs are intent on providing click-to-trade functionality, that when you accept a price on the screen with a click of the mouse, whether in an order book or via a request for quote, the trade is done. However, a trade is not done until it is accepted for clearing—something the SEFs have little if any control over. That raises the question: Can a SEF ensure a trade will be accepted for clearing before it allows the trade to execute? And even if it can, is that the SEF's responsibility?

Either way, clearing certainty is crucial to the success of SEFs. If market participants do not trust that SEF-executed trades are firm, confidence in the entire market model will erode quickly. It is critical that a mechanism be put in place to formalize this process, ensuring the market can have full faith in the trades they execute on a SEF.

There has been considerable speculation as to the number of SEFs that will exist. The wildest number I have heard is 100, which is simply unrealistic. If the U.S. equities market has 68 venues and the U.S. futures market has three main players, the swaps market will fall somewhere in the middle.

Our research shows also that nearly 60 percent of market participants believe the ideal number of SEFs per asset class is three to four, resulting in 15 to 20 SEFs covering interest rates, credit, FX, commodities, and equities. There will be many more than that to start but not 100. Our list at TABB Group shows as many as 40 firms that plan to apply. But 87 percent of our study participants believe that SEF consolidation will begin 2 years or less from the date of rule implementation.

We are now in the pre-SEF era. Business models and technology are still being finalized, but most SEFs are "registration-ready," and trade flow is beginning to pick up on the screen as most everyone has accepted that these changes are inevitable.

Even if trading mandates do not take effect until the fourth quarter of 2012—a timeframe that seems more and more realistic—the change is so enormous for most swaps traders that getting started now should present just enough time to make the switch.

As rules are finalized, it is critical that while putting in place necessary oversight, new OTC derivatives rules encourage the innovation and competition that have made the U.S. capital markets the most envied in the world.

Thank you for your time.

Chairman REED. Well, thank you very much for your testimony. Mr. Brady.

STATEMENT OF NEAL B. BRADY, CHIEF EXECUTIVE OFFICER, ERIS EXCHANGE, LLC

Mr. BRADY. Chairman Reed, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to testify on the implementation of the Dodd-Frank Act, specifically the development of SEFs. I am Neal Brady, chief executive officer of Eris Exchange, LLC.

Eris Exchange is an electronic futures exchange that began offering the trading of a cleared interest rate swap futures contract in July 2010 in response to the passage of the Dodd-Frank Act. Since its inception, Eris Exchange has traded over $33 billion in notional value of its interest rate swap futures which are cleared at the Chicago Mercantile Exchange.

Eris Exchange filed an application with the CFTC in April of this year to be designated as a contract market, or DCM. A DCM is a traditional exchange in which regulated futures contracts have been trade for over 100 years. As a DCM Eris Exchange will be permitted to list both financial futures as well as swaps. As such, Eris Exchange will satisfy the Dodd-Frank execution mandate and will operate alongside SEFs in the cleared interest rate swaps base.

My opening comments are focused on the regulatory incentives that can facilitate the successful development of SEFs. I will also comment on a few arguments heard in the industry recently related to perceived operational impediments to SEFs and how these concerns have already been solved for in the futures industry model.

First, Eris Exchange believes that the most important regulatory incentive that the CFTC can provide for SEFs is to announce clear dates for the implementation of the clearing and trading mandates. The industry is ready to trade and clear interest rate swaps. SEF-like platforms and DCMs are already connected to the major clearinghouses and are operationally ready to transact swaps and equivalent futures contracts. The market is simply awaiting a clear timetable from the CFTC before committing the resources for final implementation. As soon as the timetable is announced, customers will select preferred clearing firms and trading platforms, complete documentation, and begin final testing.

In announcing a timetable, one of the most market-based and competition-friendly actions that the CFTC can take is to implement the trading mandate soon after the clearing mandate. By mandating execution and ensuring open access to all clearing venues, regulators will foster true competition in swaps and create a level playing field for the emergence of new entrants and technology-driven innovation.

If, on the other hand, there is a significant lag between the clearing and trading mandates, incumbent firms will be heavily motivated to direct clearing to their preferred clearing venue and will transact on closed platforms dominated by incumbent firms. Such a time lag runs the risk of severely constraining the ability of new entrants to effectively compete in the execution of cleared swaps.

Second, I would like to address a few arguments heard in the industry today that are aimed at slowing down the implementation of the Dodd-Frank Act. Specifically, concerns have been raised that the documentation required for market participants to exit and clear swaps is so extensive that it will require untold hours of negotiation and impose burdensome legal costs on customers. This is an exaggerated concern.

The futures documentation structure provides a model that should be utilized as a baseline for documentation in the cleared swaps market. In the futures model there is no need for each user to enter into detailed ISDAs with every other user. For example, to trade on Eris Exchange, a participant and a participant's clearing firm need only enter into a single agreement totaling two pages, one time.

Another argument heard today in the industry is that it is impossible to trade interest rate swaps in an open, electronic order book and, therefore, the traditional OTC execution model must be maintained. Eris Exchange provides concrete evidence that this argument is flawed. Today Eris Exchange has a live, open, anonymous, electronic central limit order book offering trading for standard maturities of interest rate swap futures. Clearing firms guarantee each order and monitor risk using credit controls that are built centrally into our trading platform.

I have submitted a screen shot of the Eris Exchange central limit order book, which shows live bids and offers on our screen that are fully transactable and for which users receive instant confirmations of cleared trades with the click of a mouse.

In conclusion, it is worth noting that in the futures industry the migration from pit-based trading to screening-based trading unleashed a tremendous wave of innovation in which the U.S. derivatives industry emerged as a world leader. If regulators announce a clear timeline and apply the proper incentives, the implementation of Dodd-Frank has the potential to spur a similar technological revolution that will deliver on the real benefits of the legislation, bringing greater transparency and a wider variety of counterparties into the swaps market and thereby reducing systemic risk.

Thank you for your invitation to testify here today. I look forward to your questions.

Chairman REED. Thank you, Mr. Brady.

Mr. Macdonald, please.

STATEMENT OF BEN MACDONALD, GLOBAL HEAD OF FIXED INCOME, BLOOMBERG, L.P.

Mr. MACDONALD. Good morning, Chairman Reed and Members of the Subcommittee. It is a pleasure to appear before you today. My name is Ben Macdonald, and I am the global head of fixed income products for Bloomberg, L.P., a privately held company based in New York. Bloomberg is dedicated to registering as both a swaps execution facility and a security-based swaps execution facility under Title VII of the Dodd-Frank Act.

Bloomberg's customer base is evenly distributed amongst the buy side and the sell side. Therefore, as an independent company, we are not beholden nor are we biased toward any particular element of the market.

First of all, Bloomberg fully supports Title VII's mandatory clearing and post-trade reporting requirements. Clear and specific rules for those provisions will serve as the most significant tools for reducing systemic risk and attaining needed transparency for a reformed and financially sound derivatives marketplace that benefits all participants.

As with all new regulations, however, the devil is in the detail, and today we have concerns that these regulations will be promulgated in a way that inhibits market trading flexibility and raises the cost to the end user and, therefore, does not fully achieve the goal set out by Dodd-Frank.

We know that the systemic risk threats that arose in 2008 and 2009 were associated with insufficient clearing and post-trade price transparency and were not the result of execution failures. Trading protocols were not the problem.

We believe that Federal regulators should not go to extravagant lengths to define the most favorable terms of execution for trading for what can only be characterized as a market of sophisticated users. Rather, what should be incumbent on Federal regulators is to ensure that the market is fair and competitive and that participants themselves have enough information to assess whether they know they got a fair price or not.

One of the risks that Federal regulators run in micromanaging execution protocols is that they would increase the direct cost of trading with no real compensatory benefit to customers. In addition, they would impose artificial constraints and significant indirect costs that incentivize market participants to revert to forms of trading that evade the excessive regulation and its unnecessary costs. Ultimately, the threat is that market participants will easily find alternative ways to conduct their trading in non-SEF environments, including taking their trading to foreign jurisdictions where U.S. rules do not apply. Rather, we believe that Federal regulators should instead use a principles-based approach that encourages flexible trading protocols by SEFs.

Second, the difference in rules promulgated by the CFTC and the SEC will create significant compliance costs. Though the Dodd-Frank Act requires the two agencies to coordinate their approaches, it remains to be seen whether they will sufficiently do so in their respective final regulations. If they do not, an entity designed to operate as both a SEF and a security-based SEF will be compelled to create two separate companies to trade similar instruments.

Please note that this affects each potential SEF and security-based SEF but also their clients, many of whom currently use the same individual traders to execute both instruments. This barrier will drive a concentration in the SEF/security-based SEF space and could create a too-big-to-fail situation for the remaining SEFs in the marketplace, which is exactly the opposite of what Congress intended when it enacted Dodd-Frank.

It is our opinion that costs can be reduced by providing the opportunity for SEFs to contract with third-party service providers for market surveillance and discipline duty as long as the SEFs meet the requirements within Dodd-Frank that they retain full, ultimate responsibility for decision making involving those functions. Practical, liberal utilization of third-party service providers would enable SEFs to reduce their capital and operational costs related to the infrastructure of those functions and thereby reduce the cost of entry into the SEF marketplace.

In addition, SEFs should also be permitted to rely on the regulation and oversight performed by swaps clearinghouses rather than have to replicate essentially the same activity at the SEF level. For example, if a clearinghouse accepts a market participant or a swap for clearing, the SEF should be permitted to rely on that assessment for core principle compliance purposes under the SEF regulatory regime.

In addition, the SEC's rules on governance and financial reporting should be strictly linked to the requirements in Dodd-Frank because extending the rules beyond the Act's requirements effectively inhibits the entry of new security-based SEFs. For example, an aspiring security-based SEF such as Bloomberg, who is already independently owned and controlled, could be discouraged if faced with SEC rules that would force us to cede control of our affiliated SB–SEF to an independent board. While SEC has suggested they may require this result, it is not required by Dodd-Frank, nor is that a requirement written into the CFTC's proposed regulations.

The goals of promoting competition among SEFs, lowering barriers to entry, and allowing a consistent trading environment demand that the two Federal regulators devise coordinated rules and not work in silos. It is our hope that Congress can assist in this process.

In summary, we are concerned that we may be on the road to creating a too-big-to-fail and utility-style SEF landscape that would increase costs for the end user, encourage non-SEF trading, and ultimately reduce the benefits of central clearing and price transparency.

Mr. Chairman, on behalf of Bloomberg, I want to thank you for this opportunity to share our views on this important issue, and I am happy to answer any questions that you may have.

Chairman REED. Thank you very much, Mr. Macdonald.

Mr. Cawley, please.

STATEMENT OF JAMES CAWLEY, CHIEF EXECUTIVE OFFICER, JAVELIN CAPITAL MARKETS

Mr. CAWLEY. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, my name is James Cawley. I am chief executive officer of Javelin Capital Markets, an electronic execution venue of OTC derivatives that will register as a SEF or swap execution facility—under the Dodd-Frank Act.

I am also here today to represent the interests of the Swaps & Derivatives Market Association, which is comprised of several independent derivatives dealers and clearing brokers, some of whom are the largest in the world. Thank you for inviting me here today to testify.

Without a doubt, it is mission critical that central clearing, increased transparency, and broader liquidity is properly achieved under the act for the OTC derivative marketplace. Toward that goal, it is important that SEFs be allowed to properly function and compete with each other whereby Congress and the regulators ensure that such organizations and various execution models be neither discriminated against nor penalized by trade work flow or documentation efforts that show preference for one SEF over another.

Only by access to a fair, level, and open playing field will SEFs be properly able to play their part in the lessening of systemic risk to which the derivative marketplace contributed during the global financial crisis of 2008.

With regard to product eligibility, clearinghouses should recognize that the fair majority of interest rate and credit derivative products do qualify for clearing.

Regulators should be mindful to ensure that clearinghouses do not favor acceptance of certain products that have built in trade restrictions that impede open access or customer choice.

While intellectual property rights may protect innovation in the short term, with regard to certain swap products or indices, they may restrict trade and liquidity in the long run. Market participants should be allowed to trade such products to meet their investor or hedging objectives. Intellectual property rights for such products should adapt with the post Dodd-Frank marketplace where anonymous and transparent markets flourish.

Regulators should work with such IP holders to both ensure that their rights are properly protected but that the prudential need of the broader market is also addressed.

With regard to SEF access to clearinghouses, clearinghouses and their constituent clearing members should do as the act requires—accept trades on an "execution blind" basis. DCOs should not discriminate against trades simply because they or they shareholders dislike the method in which such trades occur.

Clearinghouses should refrain from using SEF sign-up documentation as a vehicle through which to restrict trade. As a precondition to access, clearinghouses should not require that SEFs sign "noncompete" clauses, such that a clearinghouse's other businesses—be they execution based or not—are inappropriately protected from outside competition.

Likewise, clearing firms should not require that SEFs contract with them to restrict the rights or privileges of end users as a precondition to SEF–DCO connectivity. Such requirements serve no prudential role with regard to risk mitigation and run contrary to the open access provisions of the act.

Clearinghouses should not require that a SEF purposely engage in a trade work flow that adds latency or creates unnecessary steps in the post-trade settlement process.

Instead, clearinghouses and their constituent clearing firms should draw from their own proven and well-tested experience in listed derivatives space. They should accept trades symmetrically and in real time.

Immediate acceptance of swaps trades into clearing is critical to accomplishing the goals of the Dodd-Frank Act to reduce systemic risk, increase trade integrity, and promote market stability.

Settlement uncertainty caused by time delays between the point of trade execution and the point of trade acceptance into clearing can destroy investor confidence in the cleared OTC derivatives markets.

As the CFTC has correctly asserted, such a time delay or trade latency, which in the bilateral swaps markets can be as long as a week, directly constrains liquidity, financial certainty, and increases risk.

Clearinghouses and their clearing members should do as the regulators have required and accept trades into clearing immediately upon execution on a SEF.

Regulators should be wary of certain incumbent efforts that claim to bring execution certainty through documentation. Such documentation sets in place work flow that clearly favors Request for Quote execution models over exchange-like central limit order books.

Such documentation denies the customer the right to trade anonymously with multiple counterparties because under such a work flow, the dealer counterparty requires the identity of the customer be known before the trade occurs.

This is not the case with documentation and work flow requirements in the cleared derivatives markets currently of futures and options. In those markets, buyers and sellers trade in multiple trade venues where trade integrity, counterparty anonymity, and optimal liquidity is assured through access to multiple counterparties.

Such restrictive work flow and documentation should be seen for what it is—nothing more than a transparent attempt to limit customer choice, restrict trade, and drain liquidity.

In conclusion, the role of the swap execution facility with regard to lessening systemic risk should not be understated. To fulfill the SEF's role in fostering greater liquidity and transparency, Congress and the regulators should continue to be proactive and protect the market against Dodd-Frank implementation choke points. They should continue to ensure that all SEFs have fair and open access to clearing and the marketplace.

I thank you for your time, and I am open to any questions.

Chairman REED. Thank you very much, gentlemen, for your very thoughtful testimony.

Let me just sort of lay out the logistics. We have a vote at 11, and we have another panel. I would propose 7-minute rounds, and I know we are not going to be able to ask all the questions we want to ask, so be prepared for additional questions following up the hearing. But let me begin again by thanking you for your insightful testimony.

I will address a question to the whole panel, and it has been touched upon. Specifically, in response to the CFTC's Notice of Comment, the Justice Department Antitrust Division raised some concerns about their proposed rules with respect to the ability of major dealers to control access to the markets unless there is—and the SEFs, unless there are some ownership limits, aggregate ownership limits or individual ownership limits, together with governance issues. I know you all have talked about it, but the goal I think we all share is to maximize competition while at the same time limiting barriers to entry into these platforms and into these processes.

So if you might elaborate, starting with Mr. McPartland and down to Mr. Cawley.

Mr. MCPARTLAND. It is important that we still have the major dealers involved actively. This is their market. If we talk in other areas of finance, we talk about having skin in the game. The last thing is we want are some of the biggest traders in these products not actively involved and invested in the success of these entities.

I think the language of Dodd-Frank and some of the proposed rules will ensure that we will still have open access. The access to clearing is really what will open these markets up, because it takes out a good amount of the counterparty risk, whereas now in the bilateral world, a dealer could quite rightly choose to not trade with a counterparty if they felt their credit was not up to war. The clearinghouse helps to mitigate those concerns.

But the short answer here is we need the dealers still involved. This is not about pushing them out. It is about keeping them in the position they are in and then opening up the market to more competition beyond that.

Chairman REED. Mr. Brady.

Mr. BRADY. Yes. At Eris Exchange, we do not think research and ownership are going to do everything. The people most likely to actually be new entrants and provide a credible alternative and increase competition in the space are precisely those people like the founders of our exchange who are in the market and are able to drive forward with a platform like this. We think the focus instead should be on the issues like open access, real time trade acceptance, making sure the SEFs and the clearinghouses are open and available for people to trade on.

Chairman REED. But just to follow up, so your notion is ownership is not the issue, open access. So the rules that SEC and CFTC have to come up with have to really provide an incentive for broad-based participation and prevent, regardless of ownership, so favoring one entity—I think I am restating what you said.

Mr. BRADY. Yes. I mean, that is absolutely vital, to allow anyone who is qualified and fulfills certain requirements to have access to a cleared product and access on a SEF, whether the owner of that platform, yes, I think that is less relevant——

Chairman REED. One of the issues that has come up in the context of the presence sort of an *ad hoc* system is the requirements for capital to participate are being set by the big players, basically——

Mr. BRADY. Yes.

Chairman REED. ——and there is at least some suggestion that these requirements are not necessary the market to function——

Mr. BRADY. Right.

Chairman REED. ——but they are quite conducive to continued dominance.

Mr. BRADY. Right.

Chairman REED. Do you have any comments?

Mr. BRADY. Yes. In our view at Eris Exchange and the partners that I represent, that is a much more critical issue than the actual ownership. It is the researchers on clearing or membership to clearing ought to be based on risk-based criteria and who can step in in the case of a default. In the case of the futures industry, the people who took care of the Lehman bankruptcy, for example, it was an open auction. A number of the players who actually ended up picking up the portfolio were not clearing members or non-clearing members. It was like a market-based solution, and criteria like that are much more important than ownership restrictions.

Chairman REED. Let me go to Mr. Macdonald and Mr. Cawley. Mr. Macdonald, please.

Mr. MACDONALD. Yes. I think this is a quite interesting question. From our perspective, we already are an independent company, so it is kind of disincentivizing, if you will, from a commercial perspective, to try and build a business in the SEF space that is competitive and then have to concede control of the board of that SEF. It does not really make sense. We understand and we recognize the need for governance and independence and we think that is a good thing. However, we also think there needs to be a mechanism for companies such as ourselves and other companies who are already independent to operate in this space without being penalized for being independent, and I think that goes to the crux of our issue.

I do think there is one other point which kind of touches on what Neal was saying, which is that SEFs have different models. In some cases, they take on principal risk because of the nature of their business and in some cases they do not, and I think, again, when we look at capital requirements, we need to make sure that they are commensurate with the style of SEF that we are talking about, because there clearly is not a one-size-fits-all in the SEF landscape, and there should not be.

Chairman REED. I can presume, though, that you would not object to a certain number of independent directors, for example, in the governance of these——

Mr. MACDONALD. No, no——

Chairman REED. ——the control issue.

Mr. MACDONALD. No, and we understand and we totally—I mean, we think it is a very good idea. We just think that there is a practical limit which kind of, you know, goes a little bit too far.

Chairman REED. Mr. Cawley, please.

Mr. CAWLEY. We think that whenever the dramatic change in market structure such that we are currently undergoing as a result of the crisis in 2008, one has to—the Government and regulators really should monitor and engage when necessary whenever you—when you have a marketplace moving from the haves to the have-nots. So whereas the old market in the bilateral space had ten or 15 dealers, I do not think anyone is trying to exclude them from the future. I think it is more a function of including another 25 or 30 dealers and broadening the competitive range.

And as you go and experience that change, it is important that any governance structure, whether it be at a DCO or clearinghouse or, indeed, at a SEF, have a fair degree of transparency and a fair degree of market participation on material committees that address the prudential issues concerning these organizations. It is not enough to come in and say, look, shareholders have a right, or the management have the right to enhance shareholder value. That is clear.

But SEFs, and more specifically DCOs, share a broader prudential need to the marketplace and in so doing need to address that and have open governance, which you can separate from economic interest. We just ask that it be open, transparent, and be truly representative of the marketplace, not only in terms of dealers, but also in terms of clearing members and also market participants and end users.

Chairman REED. Thank you all, gentlemen.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman, and in light of the time restraint we have, I am going to ask just one question and then try to give each of you an opportunity to comment on it, if you would like, so I encourage you also to be concise in your responses.

My question relates to the fact that the end users have expressed concern to me that many of their large or less liquid transactions may not fit within the definition of a block trade that is being proposed because of its limited nature, and they are concerned also with things like the requirement to bid trades to no fewer than five market participants or the delay built in in terms of the processing of blocked trades, and these things may create a dynamic in the market that will then drive up the cost of operations.

I would like to know—my question is, do you agree with these concerns, and if so, what can we do to address them?

Mr. CAWLEY. If I can—Kevin, do you want to go first, or—I think if you look at block trades, you have to consider the tension, Senator, on both sides. Whereas on one side there is the market need for transparency, the most important aspect or the most important information that any trader or any market participant can have is where the last trade occurred, at what price and at what time, and to go into a marketplace and not know that is putting that individual or that entity at a disadvantage.

So on one side, the customer has the right to know, or should have the right to know, consistent with other markets, where the last trade occurred. But then on the other side, large dealers and large participants are less incented to create liquidity for block trades.

So it really falls down, if you look to other markets, A, what should the size of a block trade be, and what should there be a delay, how long that delay should be such that the market maker has the opportunity to hedge their risk on such a block trade. If that time period is too short, then the market maker is loathe to make a market in such size. If it is too long, then the end user is disadvantaged.

The way we have suggested you consider that is to look to other markets, especially in the interest rate futures swap context—or in the interest rate futures context, and set a rate or a block size notional that is consistent with those markets and also a timeframe that is consistent with those other markets, as well, as a base from which to go.

Senator CRAPO. Thank you.

Mr. McPartland, did you want to comment?

Mr. MCPARTLAND. Sure. Information leakage is a big concern for all end users and by said market participants, and if we look at the swaps market, the size of the transactions and the infrequency that many of these contracts are traded makes it even more of a concern, and I think that echoes some of Jamie's points. This is why—and again, it is sort of a parallel in the equities world—this is why crossing networks developed, for example. Buy-side firms that needed to do large-side trades had a hard time doing that in the open market, so they found a new mechanism.

It goes back to my earlier comments that if we provide or allow latitude for SEFs to create market models that suit different market participants, we could end up with an environment that is suitable to doing those large-side trades. If we do not allow for that type of environment, you could force end users to look to more liquid products that they would have to do in smaller size to get their large size done. It could result in an imperfect hedge. An imperfect hedge then means more risk rather than less risk for those end users.

Senator CRAPO. Thank you.

Mr. Brady.

Mr. BRADY. Yes. We think this issue, it is a very important issue and we think it is an issue that really highlights the need for a principles-based approach to regulation because the issues are very interrelated, whether you should require five counterparties to be pinged on a request for quote and the block trade limit. If you set the block trade threshold correctly, you could have a stricter requirement to send the RFQ because if you believe in larger size, you have the flexibility to do the blocks. But every market is different. Standardized products are different than very bespoke products, and I think the futures industry is a great example of how this works. There are block trades allowed. They are set at a certain threshold that is principles-based and large size is able to be transacted when needed, but then the rest of the trades occur either in the central order book or through a very wide open request for quote process.

Senator CRAPO. Thank you.

Mr. Macdonald.

Mr. MACDONALD. I would echo all of the points that have been made. I think the key point here is actually that the end user needs to have the flexibility of means of execution. I think for the same trade, the ability to get executed or get liquidity will vary depending on a given set of market circumstances. So it is very hard to put down a set of very defined rules and think that they will work in every circumstance. They will not. And I do think that the market will, as long as it is a principle-based approach and as long as there are guidelines around execution to manage that process, I think the market will, as Kevin pointed out, reach a medium where it provides the necessary means of execution for different circumstances.

Senator CRAPO. Thank you. I will yield back a couple minutes to you, Mr. Chairman.

Chairman REED. Senator, thank you very much.

Senator Merkley, please.

Senator MERKLEY. Thank you, Mr. Chair, and thank you to all of you for your testimony.

I wanted to start, Mr. Brady, with your comments about the value of setting effective dates, for the CFTC to set clear dates for both trading and clearing, and I thought maybe I would just give you a chance to, if you wanted to advise the CFTC, what dates should be recommending that they set and why.

Mr. BRADY. Yes. I mean, the general point that we would like to stress is we believe the marketplace is ready. I mean, you have examples of platforms and swap execution facilities that are ready and operational today, connected back to clearinghouses. In our view, the market is really looking for a clear signal to focus around and then motivate people to make decisions, commit resources, and a lot of the issues we are discussing today in the industry really can be settled with people who are highly motivated and with a deadline to reach a lot of sort of the documentation issues, the credit control issues, these sorts of issues.

We have put forth in various comment letters a timeframe that talks about completing all the final rules through the end of this year, allowing provisional registration of SEFs so we do not slow down that process, you know, beginning with some clear mandates starting first quarter, second quarter of next year, starting with the most sophisticated users, mandates on those users and then moving in sort of a sequenced process through the less sophisticated people who have more operational issues. So we think that is the type of time table. If it were laid out clearly from the regulators, you would see a tremendous amount of focus and innovation and sort of work toward achieving those goals.

Senator MERKLEY. And do you picture between the sophisticated users and the balance of the marketplace a 3-month transition, a 6-month transition, a year transition?

Mr. BRADY. Yes. I mean, I think that is—we do not have a specific recommendation, but we think sort of quarterly rolling in different layers of participants would make some sense.

Senator MERKLEY. So let us say the initial deadline on trading was, say, March 2012. Do you picture the clearing date being the same date, or a difference there?

Mr. BRADY. You know, I think—we think some type of lag between those two would make some sense operationally, but not a significant one. So lagging it by a couple of months or a quarter could make some sense. We also think allowing for some voluntary compliance, maybe the first quarter of 2012 includes voluntary compliance with the clearing mandate. People work out the plumbing and test rates would certainly seem to make a lot of sense.

Senator MERKLEY. Does anybody have a radically different opinion they want to share on this?

So I wanted to turn, second, to a point a couple of you mentioned, which was a separation of the trading and clearing dates and the lack of confidence if your trade is not a trade until it is cleared at some future point. It is my understanding in the commodities market that these are done simultaneously. What is driving that separation and how long of a time lag are we talking about, and is it a startup problem to have those things happen simultaneously or some type of long-term structural philosophical fight going on here?

Mr. BRADY. If I could, maybe I will just start by talking about how it works in the futures model——

Senator MERKLEY. Great.

Mr. BRADY. ——and then hand it over to the other participants here. I mean, the futures model, the essence of it is that there is a pretrade credit check. So, for example, in the Eris exchange platform, there are credit controls on the platforms and if you see a bid or an offer for a 200-million size 5-year swap quote, that has been preapproved and there is a clearing firm standing behind that quote. In addition, when you submit a block trade, we have credit controls at the clearinghouse, I mean, on entry to the clearinghouse. So either the trade is submitted and it is good or the trade never existed. It is rejected for credit.

The SEF model, and I will let the others comment on that, today, we are working through those issues where the SEF is not directly connected to the clearinghouse, and I will let others comment on how that is being worked out.

Senator MERKLEY. OK.

Mr. CAWLEY. So on its face, Neal is correct, Senator. Real-time acceptance of trades in the futures context works and has worked well for many years, whether it be on an exchange or in the clear port example with CME in a more decentralized basis. That is something that the CFTC and regulators have called for with suggested rules for the OTC space and we do not see from where we sit a problem with that. The MFA has also come out in support of, as has the STMA, come out in support of real-time acceptance of clearing.

And if you think about it, it is really mission critical to the success of clearing because it really comes down to the fundamental integrity of the marketplace. Whereas in the bilateral market space, trades would go unsettled a few years ago, even for as many as 3 or 4 years, now, that window is down to a few days or a week. But that is still, relative to other markets, quite a long time. So it creates an uncertainty between the SEF and the DCO and ultimately it ends up with a customer having lost faith in the marketplace. So the technology is there now to use and is available and people are working toward these.

Senator MERKLEY. So I want to back up and see if I heard you correctly. You say that commodity trades in the near past sometimes were unsettled for 3 or 4 years?

Mr. CAWLEY. CDS trades, certainly, yes. Back in 2003 to 2004, there were many trades that have been unsettled. Some trades have actually gone—had matured before they had settled.

Senator MERKLEY. Hmm. OK.

Mr. MCPARTLAND. So one of the big differences between the futures market and the new sort of SEF cleared swaps environment, in the futures market, you have one exchange feeding one clearinghouse. In the swaps environment going forward, we are going to have many execution venues feeding many clearinghouses. So that makes ensuring that the execution venues and the clearinghouses all have the most up-to-date information a much more complex process.

Now, to Jamie's point, the technology certainly exists to allow that. There are a few thoughts about how this would work. Some think that we should have a central utility that will look at all of the limits and the client accounts at the clearinghouse and hold that and feed that information out to all the SEFs and clearinghouses. There is also a thought that the clearinghouses, since it is about the clearing account, that they will hold the information and when they get a new trade they will broadcast that out to all the relevant SEFs and the other clearinghouses.

Many of the dealers, though, are concerned that they do not want to have to give up essentially their risk models that they use to determine how much a client can trade to an outside party. So many of the big dealers would rather—as they say, we will tell you when to stop a certain client from trading. We will let you know.

So, again, as Jamie said, the technology is certainly there, but I think it is more of an operational concern than it is a technology concern.

Senator MERKLEY. All right. Thank you very much.

Chairman REED. Thank you, Senator Merkley.

Senator Corker, please.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony, and for what it is worth, I thought your answer to Senator Crapo's question, considering that each of you sort of benefit from these new regulations, was pretty judicious, and I thank you for that and for being forthcoming in that regard.

I would ask this question. Back home in Tennessee, people are saying, you know, we wish that you guys would quit helping us the way that you are in Washington. Who is it that we are actually helping with the creation of these SEFs? You know, we met with some of the big traders Monday and the big market makers obviously are not being helped by this in any way. So who is it that we are helping?

Mr. BRADY. I would be happy to start with that. If implemented correctly—you know, it is a big if—we believe principles-based is the way to go. But if implemented correctly, we believe the ultimate end users, the asset managers, the people who are the end users of swaps products would have more transparency if these systems were able to connect correctly, there were real-time trade acceptance, and you had price feeds on which you could rely for transactable swap prices.

Senator CORKER. So, I mean, I thought you all, again, judiciously answered the question, but when you have got a large block trade and you are used to dealing—your client, a BlackRock or a PIMCO, is used to dealing with a certain dealer and they want to unload a position and they are willing to take it, it does seem that this is a problem as it relates to people being able to front run, if they have got to report too quickly. I mean, that is a heck of a problem, is it not?

Mr. BRADY. Yes, and that is why it is absolutely critical to get that block trade threshold right. And again, just to point to the futures market, the BlackRocks, the PIMCOs, those players are very active participants in the futures market and they use the transparent order book, and then when they need to——

Senator CORKER. Yes, but futures are a little bit different. That is a little bit more of a plain vanilla market than can happen with swaps, is that not correct?

Mr. BRADY. Well, there are a number of standardized vanilla swaps that are actually very like futures. I mean, that is the issue of for standardized swaps. That is generally what we are talking about trading in a central limit order book or——

Senator CORKER. So let me ask you this question. So let us say that you are involved in a large trade and you are creating liquidity for a client, and right now, I know the CFTC is talking about reporting in 15 minutes. It is pretty hard to unload a big book in 15 minutes. What is—why not end of day reporting? Why have a 15-minute reporting guideline?

Mr. BRADY. I mean, again, I think that is our position on that and the partners in our exchange would be that is where principles-based regulation is important——

Senator CORKER. So end of day would be fine on the large——

Mr. BRADY. I think it depends on the marketplace. I think every market is different. Different swaps require different treatment.

Mr. CAWLEY. Senator——

Senator CORKER. I would love to have some other input here. It sounds like you all are actually in agreement that 15 minutes is way too short.

Mr. CAWLEY. Well, it really—we are not in agreement with that, Senator. I think 15 minutes for the futures market is pretty consistent with the liquidity that is offered within the interest rate swap market and certainly indices, which is 40 percent of the credit derivatives market. Fifteen minutes by certain market participants is viewed as too long.

I think it really comes back to Neal's point, which is it is specific to the liquidity in a particular marketplace. If you look to the futures world or the exchanges today, it is 15 minutes. At some point, it was an hour, and at some point, it was end of day when the markets were less liquid.

So the key thing, then, is to measure the amount of liquidity within the marketplace that allows that market maker the opportunity to trade out of that position and to hedge it appropriately. And when you are talking about 2-year interest rate swaps that their average ticket size is $400 million at a clip, that is pretty good liquidity.

Senator CORKER. So it is kind of interesting, do you not agree, that on one hand, we have castigated the heck out of high-frequency trading in equities and yet we are moving toward sort of algorithm-type trading on the swap side. I mean, is that an interesting——

Mr. MCPARTLAND. Yes. Well, I can comment on that, Senator.

Senator CORKER. OK.

Mr. MCPARTLAND. So the alternative, if the block trading rules are too onerous and the market sees that that will create too much information leakage, the alternative will be to then take your $400 million and use an algorithm to split it up into——

Senator CORKER. Right.

Mr. MCPARTLAND. ——400 trades and spread it all across a variety of SEFs, which is exactly what happened in the equities market and I think some feel that that has made the equities market more liquid, but others feel that it has made it much more complex to understand who is doing what and what is going on.

Senator CORKER. But you would agree that we sort of have a bipolar way of thinking here. On one hand, we want to move away from that on equities, but on the other hand, we are driving toward that in swaps.

Mr. MCPARTLAND. There is no question, and I am in the process of research now where we have been talking to a number of the proprietary trading firms about this issue. Now, let us remember that in equities, as well, they provide a lot of liquidity to the market and then it also brings—ensures that prices are much more in line. So futures prices, swaps prices, everything will line up much more closely than it does today, and that should ultimately result in better prices for the end user who needs to do an interest rate swap to hedge their loan book.

Senator CORKER. So we actually watched—I watched one occur. It is not that interesting, actually. But we watched this occur a little bit on Monday, and it is kind of, like, if I am a client and I have been used to dealing with X dealer and now I have got to get five bids, if you will, that just seems ridiculous to me. I mean, if I want to—if you look at the spread difference, it is very, very minor in these trades. Is that not onerous to make a client that does this on a daily basis have to get five bids? Is that not just ridiculous?

Mr. MACDONALD. Senator, I think what we are really talking about here—we keep on going back to the point of flexibility. The reality is that in any given set of circumstances——

Senator CORKER. But the CFTC is not acting as if they are giving flexibility. They are talking 15 minutes and five bids. So you are saying that is wrong, is that correct?

Mr. MACDONALD. Our thought currently is that it is very hard. Two things will likely happen if you are prescriptive about exactly what RFQ needs to do and about reporting deadlines. As the market evolves and liquidity changes, people may not actually be able to get execution or may not actually want to go out to that level of market players for their own shareholders' reasons and dispute what we thought we are actually creating—we actually may be creating more risk by being prescriptive about protocols versus having a principles-based approach which gives people a framework to operate and gives them the flexibility to adapt to their business models.

Senator CORKER. And just—I know my time is up—a lot of concern about folks with these new rules that we are putting in place with developing markets going elsewhere, not sort of the industrialized countries, but Latin America and other places, living, having to live by our rules, will go outside of the U.S. to execute. Do you all not have similar concerns based on, again, what CFTC and others have laid out thus far?

Mr. MACDONALD. Well, I think, clearly, we operate in a very global market and a lot of entities are—there are a lot of U.S.-based entities, but there are also a lot of other regional entities, and I think that insofar as we create difference in regulation, although it exists, different regulation regimes, I think at the end of the day, entities will go to wherever they feel the regime is most appropriate for their activities.

Senator CORKER. So the answer is yes.

Mr. MACDONALD. Yes.

Senator CORKER. So, Mr. Chairman, this has been a great hearing. I do hope, maybe—in listening to the testimony, these guys all benefit from what we are doing, I mean, and I am glad they are here. They are going to make a lot of money off what we have done and I am glad they are. But they themselves are talking about some of the frailties and maybe there is something we might do together letter-writing-wise to CFTC to make sure that what they do is not so rigid and prescriptive that we actually have unintended consequences. I thank you for the hearing and thank you for the time.

Chairman REED. Thank you, Senator Corker. And just let me return to the point that Senator Crapo made, which is the idea of coordinating as much as we can imagine, a unified set of rules that apply to the SEC-regulated entities, which is our jurisdiction, and the CFTC entities, which is the jurisdiction of the Agriculture Committee, but I think one strong message that you want to send today based on this testimony and based on Senator Corker's comments is a notion of sensible unified rules that our industries can profit by, and not only industries, but the end users and the community at large.

I think one of the points, and raise your hand if I am way off base, but we have seen in equity trading, because of the efficiencies brought to the market, that the spreads have come down considerably with the benefit of people who buy and sell stocks every day, and that is a lot of people, pension funds, all sorts of folks. And I think my sense is, based on your testimony, we will see the same thing if we get this right in terms of the swaps market, and that would be useful to the whole economy, a more efficient economy. But I think, Senator Corker, we certainly hope that our colleagues across the way in CFTC and SEC pay close attention to what is said today, and we can follow up with them.

Senator Hagan, you have arrived. We have a panel. Your questions.

Senator HAGAN. Yes. Thank you, Mr. Chairman. I appreciate that.

Mr. Macdonald, in your testimony, you state that Bloomberg intends to be prepared to begin swap execution facility operations on the implementation of regulations by the CFTC and the SEC, provided that the two regulators create synchronized rules governing trading protocols, board composition, and financial reporting. Would you like to comment quickly on how that synchronization is progressing, and also, I would like to ask, why are trading protocols, board composition, and financial reporting important to your ability to begin operations, and can you address each one individually?

Mr. MACDONALD. Sure. So from our perspective, we are ready to operate as both a swaps execution facility and a security-based execution facility. I cannot talk specifically to the cooperation between the CFTC and the SEC because obviously I spend most of my time in New York. That said, when we look at the facts as we know them today, there are a couple of areas that raise some concern for us when we look at becoming both a swaps execution facility and a security-based execution facility, namely the one that we will have to actually create two companies that have different board requirements in order to operate in markets that are very similar in terms of the end user base. So our concerns are really more around—and I will address, first of all, the governance and the independence, and then I will address the trading protocols.

From a governance and independence perspective, we understand and we recognize the need for independence in both the kind of the company structure and the governance around the swaps execution facility for obvious reasons. Our point is that we are already an independent company, so forcing us to put independence on top of independence does not really make sense from both a commercial and a structural perspective, and that is one of the things we are looking at. We know that the CFTC has slightly different rules in that regard than the SEC. The SEC requires a majority of the board to be independent, whereas the CFTC only requires 35 percent.

When we talk about trading protocols, our point is really that of our customers. We are, as an institution, just an intermediary between buyers and sellers, and our view from a very long experience in this market is that it is very hard to have a one-size-fits-all when you talk about RFQ or, indeed, any trading protocol, and there are two main reasons for that.

First, if you define a specific protocol, the issue that you will face is that as the market evolves and the liquidity does change in these markets, that protocol may become inappropriate and actually increase more risk in a given set of market circumstances than it would reduce risk.

The other point that we would make is that by not using a principles-based approach and by being prescriptive about the types of protocols, what happens is that it will make the market less competitive and more utility style because people will not be able to innovate because they are constrained in terms of what they can do as a SEF. So those would be the points we would make.

Senator HAGAN. Thank you.

Let me ask also Mr. Macdonald, also in your testimony you noted that elaborate execution protocols will increase the direct cost of trading and could drive business off of the swap execution facilities or, what I would hate to see, into foreign jurisdictions. How would you judge the proposed rules that are coming out of the CFTC and the SEC against this standard?

Mr. MACDONALD. Well, you know, we think—and, you know, when I talk about an RFQ, a minimum of five or in the SEC's case an RFQ with resting orders for the winning bid. I think the issue with these is really what will happen is they can create direct costs for a number of reasons, firstly, because of this element of what people call the winner's curse, *i.e.,* the fact that I know that I have got four other people in competition with me on that trade means that people are not necessarily in every circumstance going to want to show the best price as possible because the result of four people knowing that that trade got executed in the market means when the entity that did win the trade has to turn around and go and hedge that out, then there are four people in the market who know that that hedge activity is about to happen in the interdealer market, and that will have an impact on price and, therefore, a direct impact on the end user.

Another point which is perhaps a little bit less obvious is that what may happen in order to mitigate that risk is the execution size will get reduced, and so people will actually execute in smaller sizes in order for that kind of winner's curse or information not to be as apparent in the market. What that has is a direct operational cost on the end user, so I will give you an example. If I am a fund manager and I have to do an allocation on a trade, so I may want to do a block trade for, let us say, 100 million and want to allocate that out to 50 funds, if I go out and I actually have to—instead of just doing one trade and one set of allocations, I actually have to go out and do five trades to reduce the size. I now have to do 250 allocations, which significantly raises the cost on me as an end user in terms of processing that trade.

So that is what we mean by raising the direct cost.

Senator HAGAN. And how about the threat of sending those offshore?

Mr. MACDONALD. Well, I think it is clear, you know, that this is a global market, and I think when we look at the regulatory proposals that we see in the U.S. versus what we see in Europe and other jurisdictions, the risk that we highlight is one where different regions have different regulations, and then, you know, companies that are not subject to U.S. rules will make the decision as to whether they want to operate inside the U.S. or outside the U.S. for trading activity. And, you know, that I think is a valid risk.

Senator HAGAN. Thank you.

Mr. McPartland, you raised what I think is an important issue, and with the proliferation of SEFs and clearinghouses, how will credit risk be managed across entities? And do you see this as a potential source of systemic risk?

Mr. MCPARTLAND. The technology certainly exists to manage the problems, but operationally it is very, very complicated when we have a number of different entities with different needs and different end games. We should not try to regulate how this should work; however, the industry needs to come to some consensus as to how these issues will be resolved before the market can move forward effectively.

The faith in a SEF execution is very much based on the industry's knowledge that it will be accepted for clearing, and that goes to the point of ensuring that the interconnectivity between the SEFs, the clearinghouses, the swap data repositories is all very well defined and available to the market participants.

Senator HAGAN. And how will the industry come together to make these decisions?

Mr. MCPARTLAND. Well, the industry has been working together for the last few years obviously on many of these issues through the industry bodies. It is in everybody's best interest to ensure that this does work. The changes are coming. So, you know, to that, the more efficient that the process can be, the easier it will be for everybody to modify their strategies and their business approach to work in the new environment.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman REED. Thank you very much.

Please, Senator Toomey.

Senator TOOMEY. Thank you very much, Mr. Chairman.

I just have one quick question for any of the panelists who would like to respond to it. That is, the fact that the SEC and the CFTC have different rules, rules that are—especially with respect to, for instance, the number of dealers who would have to quote on a price, the timing that would be required to intervene before the disclosure of block trades, frankly it does not make a lot of sense to me. I understand they regulate slightly different kinds of contracts, but at the end of the day, is it your view that we ought to harmonize this and we ought to have the same requirements between the CFTC and the SEC?

Mr. CAWLEY. Well, Senator, let me attempt to answer that. The SEC regulates credit derivatives, and the CFTC regulates interest rate swaps and indices. And I think when you consider those three different swap classes, there are different liquidity considerations in each. So consequently there should be different block size of block trade reporting requirements in terms of size and also in terms of time. So it is certainly consistent that they would have different views for each particular class, especially when you look to other asset classes where similar rules exist, but be it in futures or options or even in the equity markets.

With regard to your concern vis-a-vis RFQ and the potential limitations that that may have on liquidity, whereas on the one hand a customer is loath to put their name, size, and direction out on a particular trade to multiple counterparties, one also has to measure it against the tension by giving it out to too few. One of the suggestions from the SEC, for example, has required that an RFQ go out to one entity. We think that that is fraught with danger from a market manipulation standpoint, and we should protect against that.

Our customers certainly have the ability to go out to five or three or whatever the number is. I do not think they are looking to go out to see 10 or 15 or 20.

Under those certain rules, they do not necessarily have to show their name in addition to size and direction. They can initiate what are known as "anonymous RFQs," and they can certainly access the central limit order book or the exchange marketplace as well so they can avoid the RFQ requirement altogether. So there are certainly many avenues for customers to come in and trade.

Senator TOOMEY. Mr. McPartland, I wonder if you have a different perspective on this.

Mr. MCPARTLAND. I think Jamie raises some very valid points. The credit market, the rates market are very different. They have very different users, very different uses for those products.

However, I would suggest that the regulations should be considerably more harmonized than they are, and it would be left then to the SEFs and the market participants to ensure that the SEFs that are focused on trading credit derivatives are designed in such a way that it helps liquidity in those markets, and the same for the interest rate markets. So rather than regulatory differences, we would have differences in business models in the SEFs that are trading in those products.

Senator TOOMEY. Mr. Brady, anything you would care to add?

Mr. BRADY. I think we are returning to the theme, a number of us, of urging the regulators to take a principles-based approach. Certainly more harmonization between the CFTC and SEC is welcome. But I think we also recognize that markets are different, and both agencies should strive to take a principles-based approach.

Senator TOOMEY. Thank you.

Mr. Macdonald.

Mr. MACDONALD. Sure. I think there are broadly three things here. The first is that as it pertains to block sizes and trade reporting requirements, I think clearly there are nuances between each element in these markets, and whatever the end regulations will be should be reflective of that.

I think when we talk about execution protocols, you know, I would echo what Neal said, which is that it needs to be a principles-based approach. I think it is important to note that there is quite a strong correlation between the single-name space, which would be regulated by the SEC, and the index space, which would be regulated by the CFTC, and, therefore, it is important that users have a similar experience on executing on both of those platforms.

The last point I would like to make is really the one about governance within thesecurities-based SEF space. I think it is clear that the population and size of the market that will be regulated by the SEC is much smaller than the one which is going to be regulated by the CFTC. And I think that if the barriers to entry to the SB–SEF space and the governance rules that will be put in place by the SEC are prohibitive, I think what you may end up having is a mismatch between the platforms that operate in the index and swap space versus the platforms that operate in the single-name space, because it may not be commercially viable for somebody to build an entity or a company to operate in the SEC space.

Senator TOOMEY. Thanks, Mr. Chairman.

Chairman REED. Thank you, Senator.

Thank you, gentlemen for your excellent testimony, and I will ask the next panel to come forward. Thank you.

[Pause.]

Chairman REED. I would like to recognize my colleague, Senator Toomey, to introduce Mr. Thum. Senator.

Senator TOOMEY. Thank you very much, Chairman Reed, for giving me this opportunity to introduce Mr. William Thum, a principal of the Vanguard Group in Valley Forge, Pennsylvania. Vanguard is, of course, one of the world's largest investment management companies, employing over 12,000 people in the United States and abroad. Mr. Thum is currently the senior derivatives transactional and regulatory specialist in Vanguard's Legal Department. Try saying that five times fast.

Prior to joining Vanguard in 2010, Mr. Thum was a partner with Fried Frank Harris Shriver & Jacobson, LLP. From 1998 to 2007 he was an executive director and head of institutional securities documentation for the Americas at Morgan Stanley. From 1996 to 1998 Mr. Thum was a vice president and head of derivatives documentation at UBS. He also worked at BNP Paribas in New York and at Dresdner Klein Ward in London as legal counsel. Mr. Thum has been an active contributor to industry efforts to develop market standard documents for derivatives trading. He is a frequent lecturer on legal and regulatory issues relating to derivatives and has participated in several joint CFTC/SEC public roundtables on Dodd-Frank Act-related rulemaking.

Mr. Thum received his J.D. from the American University Washington College of Law and his B.A. from Bucknell. He is admitted to the bar in both New York and Pennsylvania, and I am very pleased that Mr. Thum could be with us today. I welcome his testimony, and I thank you, Mr. Chairman.

Chairman REED. Thank you, Senator. Let me introduce our other panelists.

Stephen Merkel is executive vice president, general counsel, and secretary of BGC Partners, positions he has held since the formation of BGC's predecessor eSpeed in 1999. He is the current chairman and a founding board member of the Wholesale Market Brokers' Association, Americas, the independent industry body representing the largest interdealer brokers operating in North America wholesale markets across a broad range of financial products. He serves as a member of the supervisory board of ELX Futures, L.P., a fully regulated electronic U.S. futures exchange. He is currently also executive managing director, general counsel, and secretary of Cantor Fitzgerald, L.P., which he joined in 1993. Thank you, Mr. Merkel, for joining us.

Christopher Bury is a managing director at Jefferies & Company in the fixed income's New York office and cohead of rates trading and sales. Under Mr. Bury's leadership, Jefferies has expanded its global rates trading and sales capabilities, including attaining primary dealer status with the Federal Reserve Bank of New York as well as the equivalent dealer recognition in multiple European countries. Prior to joining Jefferies in January 2009, Mr. Bury spent more than 13 years in fixed income trading at Merrill Lynch, where he most recently headed Merrill Lynch Government Securities, Inc., and was trading manager of the USD agency desk. Prior to trading agency debt, Mr. Bury traded USD interest rate swaps and options for Merrill Lynch.

Gentlemen, your testimony will be made part of the record. Please use your 5 minutes to make any comments that you would like. Mr. Thum, please.

STATEMENT OF WILLIAM THUM, PRINCIPAL AND SENIOR DERIVATIVES COUNSEL, THE VANGUARD GROUP, INC.

Mr. THUM. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for having me here today. My name is William Thum, and I am a principal and senior derivatives counsel at Vanguard.

Headquartered in Valley Forge, Pennsylvania, Vanguard is one of the world's largest mutual fund firms. We offer more than 170 U.S. mutual funds with combined assets of approximately $1.7 trillion. We serve nearly 10 million shareholders including American retirees, workers, families, and businesses whose objectives include saving for retirement, for children's education, or for a downpayment on a house or a car.

Vanguard's mutual funds are subject to a comprehensive regulatory regime and are regulated under four Federal securities laws. As a part of the prudent management of our mutual funds, we enter into swaps to achieve a number of benefits for our shareholders including hedging portfolio risk, lowering transaction costs, and achieving more favorable execution compared to traditional investments.

Vanguard has been supportive of the Dodd-Frank Act's mandate to bring regulation to the derivatives markets to identify and mitigate potential sources of systemic risk.

Vanguard supports a phased implementation schedule over an 18- to 24-month period following rule finalization based on the following objectives:

Number one, prioritizing risk reduction over changes to trading practices and market transparency; Prioritizing data reporting to inform future rulemaking related to trading practices and market transparency to minimize a negative impact on liquidity; Harmonizing overlapping U.S. and global regulatory efforts; and Allowing immediate voluntary access for all party types to the new platforms with mandated compliance to apply initially to swap dealers and to major swap participants.

In view of the time needed to digest the final rules and to develop industry infrastructure; to implement complex operational connections required for reporting, clearing, and exchange trading; to educate clients on the changes and to obtain their consent to trade in the new paradigm; and to negotiate new trading agreements across all trading relationships, Vanguard supports the following implementation schedule:

Six months from final rules, the swap data repositories, derivatives clearing organizations, SEFs, and middleware providers must complete the build-out of their respective infrastructures.

Six to 12 months from final rules, all participants should voluntarily engage in reporting, clearing, and trading platforms.

Twelve months from the final rules, all participants should be mandated to report all swaps involving all parties. Dealers and major swap participants should be mandated to clear the first list of standardized swaps.

Eighteen months from the final rules, all participants should be mandated to clear the first list of standardized swaps. SEFs and commissions can analyze SDR swap data for liquidity across trade types to make informed SEF trading mandates, block trade size, and reporting delays. Dealers and major swap participants should be mandated to trade the first list of standardized swaps made available for trading on SEFs.

And 2 years from the final rules, all participants should be mandated to trade the first list of standardized swaps made available for trading on SEFs with delayed public reporting of block trades based on historical relative liquidity.

The need for a phased implementation schedule is supported by studies which have identified significant differences in liquidity between the swaps and futures markets. While futures trading is characterized by high volumes of a limited range of trade types of small sizes and limited duration, the swaps market has an almost unlimited range of trade types of much larger sizes with a much longer duration. Swaps liquidity varies dramatically with high liquidity for 2-year U.S. dollar interest rate swaps and much smaller liquidity in credit default swaps on emerging market corporate entities.

The potential negative consequences to liquidity are best demonstrated by the impact of the premature public reporting of large-sized block trades. When quoting a price for a block trade, dealers typically charge a slight premium to the then current market price for a similar trade of a more liquid size. Once the trade is executed, the dealer executes one or more liquid-sized mirror trades at current market prices to lay off its position and to flatten the market exposure.

The premature public dissemination of block trades will provide the market with advance knowledge of the dealer's imminent trading and is, therefore, likely to move the market against the dealer. Fund investors will ultimately bear the increased price of relevant trades or the increased costs of establishing positions using multiple trades of liquid sizes.

The CFTC's proposed test for block trade size and the CFTC and SEC's proposed time delay for the public dissemination of block trade data are too conservative and are likely to have a serious negative impact on liquidity. Particularly as such proposals address market transparency and not market risk, the more prudent approach would be to make informed decisions based on a thorough analysis of market data with larger block trade sizes and more prompt public reporting for the most liquid products and lower sizes and delayed reporting for less liquid products.

There are a number of other significant issues related to SEF trading mandates proposed by each of the CFTC and SEC which I am happy to discuss. Such issues include the CFTC's proposed requirement for Requests for Quotes to be distributed to a minimum of five dealers, the CFTC's and SEC's mandate for participants to take into account or to interact with other resting bids and offers, the CFTC's requirement for there to be a 15-second delay involving crossing trades, and the need for harmonization across the CFTC and SEC rulemaking to avoid unnecessary complexities.

Thank you for the opportunity to share our views with the Subcommittee, and we will be pleased to serve as a resource for the Members with respect to the swaps rulemaking exercise.

Chairman REED. Thank you very much.

Mr. Merkel, please.

STATEMENT OF STEPHEN MERKEL, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, BGC PARTNERS, INC.

Mr. MERKEL. Thank you, Chairman Reed and Ranking Member Crapo, for providing this opportunity to participate in today's hearing.

My name is Stephen Merkel, and in addition to my role at BGC Partners, I am the chairman of the Wholesale Markets Brokers' Association, Americas, an independent industry body whose membership includes the largest North American interdealer brokers. I am here today representing the members of the WMBA.

The WMBA recently filed a comment letter to the SEC and CFTC summarizing the positions we have taken on several of their proposals over the last year. I would ask permission to submit this letter for the record.

Chairman REED. Without objection.

Mr. MERKEL. Thank you.

Wholesale brokers are today's marketplaces in the global swaps market and, as such, can be a prototype for prospective independent and competitive swap execution facilities, or SEFs. As we sit here today, interdealer brokers are facilitating the execution of hundreds of thousands of over-the-counter trades corresponding to an average of $5 trillion in notional size across a wide range of asset classes. Although the Dodd-Frank Act created the term "SEF," the concept of counterparties to a trade utilizing an intermediary to execute transactions has been around for a very long time.

At the core of Title VII is a competitive marketplace. The Dodd-Frank Act specifically did not dictate that all mandatory trades go through monopolistic exchanges and instead permits these trades to be executed across an array of over-the-counter competitive SEFs. SEFs do not operate as siloed, monopolistic exchanges. Instead, we operate as competing execution venues where BGC and its competitors aggressively vie with each other to win their customers' business through better price, provision of superior market information and analysis, deeper liquidity and better service. It is vital to ensure that SEFs are brought under the new regulatory regime in such a way that fosters the competitive nature of OTC markets and continues to provide a deep source of liquidity for market participants.

WMBA member firms are currently fully functional, having the capacity to electronically capture and transmit trade information with respect to transactions executed on our trading platforms as well as the ability to execute or trade swaps by accepting bids and offers made by multiple participants through any means of interstate commerce, including use of electronic and voice trading platforms.

I would suggest that there are four critical elements regulator need to get right.

First, SEFs must not be restricted from deploying the many varied trade execution methods successfully used today.

Second, regulators need to carefully structure a public trade reporting system that takes into account the unique challenges of swaps trading. If the rules do not properly define the size of block trades, information, and time delays, it will sure cause a negative impact on liquidity, disturbing end users' ability to hedge commercial risk and to plan for the future.

Third, the goal of pretrade transparency must be realized through means that are already developed by wholesale brokers to garner and disseminate pricing information, and not by artificial mechanisms that may restrict market liquidity for end users and traders.

Finally, regulations should support the formation of a common regulatory organization for SEFs to implement and facilitate compliance with the new regulatory regime to prevent a "race to the bottom" for rule compliance and enforcement programs. As it relates to modes of execution, Dodd-Frank Act expressly permits swaps to be executed by SEFs using any means of interstate commerce. The WMBA believes the SEC's interpretation of the SEF definition is consistent with the statute as it allows trade execution through any means of interstate commerce including requests for quotes systems, order books, auction platforms, or voice brokerage trading.

WMBA believes that this approach should be applied consistently to all trading systems or platforms and will encourage the growth of a competitive marketplace for trade execution facilities. By contrast, the CFTC's pending rule is much more restrictive than Dodd-Frank's express language and prescribes specific modes of execution for different types of trades.

In fact, the CFTC's proposed rule would severely limit the ability of SEFs to communicate with their customers telephonically in the course of a transaction. Such a limitation of voice communications is completely inconsistent with the statute.

I thank you for your time and look forward to answering any questions that you may have.

Chairman REED. Thank you very much.

Mr. Bury, please.

STATEMENT OF CHRIS BURY, COHEAD OF RATES SALES AND TRADING, JEFFERIES & COMPANY, INC.

Mr. BURY. Good morning. My name is Chris Bury and I am the Cohead of Rates Sales and Trading for Jefferies and Company. Chairman Reed and Ranking Member Crapo, thank you for inviting me to testify this morning regarding the emergence of swap execution facilities, or as they have come to be known, SEFs.

Jefferies is a full-service global securities and investment banking firm that, for almost 50 years, has been serving issuers and investors. We provide investment banking and research, sales, and trading services and products to a diverse range of corporate clients, Government entities, institutional investors, and high net worth individuals. Over the last 5 years, our firm's annual revenue, equity market capitalization, and global head count have increased significantly, with now almost $3 billion in annualized net revenue, over $4 billion in equity market value, and soon to be 3,600 employees.

It bears noting that during the same period, that is, during the financial crisis, at no time did Jefferies seek or receive taxpayer assistance. As a publicly traded company on the New York Stock Exchange, our capital comes solely from the markets, and Jefferies' ability to persevere and emerge from the financial crisis positioned for growth and diversification can best be attributed to the firm's focus on a strong capital position, ample liquidity, and sound risk management.

There are a few key points that Jefferies would like to convey to the Subcommittee. First, we are ready to go. From our perspective, the architecture, infrastructure, and technology necessary to bring the over-the-counter derivatives markets into an era of transparency, disperse counterparty risk, and open access are in place. Just as we are a leading provider of liquidity and execution in stocks and bonds, we believe we can become a leading provider to buyers and sellers of derivatives. The market awaits the adoption of final rules. It is a fallacy to suggest that rules should be delayed to allow more time for this market structure to develop.

Second, we believe that those sections of Title VII of Dodd-Frank pertaining to SEF trading of derivatives are necessary to remedy the artificial barriers to entry in the OTC derivatives market.

Third, implementation time lines should be the top priority at this juncture. The proposed rules are generally clear and understandable. The market needs the certainty of when the rules will become applicable far more than it needs any more suggestions about how bilateral agreements offer an alternative to central clearing.

Fourth, it is vitally important to guard against the development of market structures that enable opaque, bilateral contract relationships to continue to exist. Current standardized execution agreement proposals for centrally cleared swaps do nothing but preserve the closed and anticompetitive elements of these markets as they existed prior to the financial crisis.

Fifth, the adoption of the rules and a clear time line for implementation for Title VII will bring to the markets the same clear benefits gained from similar developments in equities and futures markets: Increased access, expanded competition, improved price transparency, and decentralized risk. For years, firms such as Jefferies were effectively locked out of being a dealer in the OTC market by virtue of a series of artificial barriers and requirements that perpetuated a closed system. The weaknesses and lack of true competition of that closed system exacerbated the credit crisis of 2008 to the great expense of our economy.

We support the implementation of SEF trading as quickly and responsibly as possible. We believe that these provisions will increase transparency, reduce systemic risk, increase competition, and broaden access to centralized clearing within the derivatives marketplace, all of which will benefit the American taxpayer.

Our industry is approaching full readiness for standardized OTC derivatives contracts to begin trading on SEFs. If the proposed rules are implemented by the end of 2011, Jefferies would anticipate that trading volumes will begin increasing by the fourth quarter of this year, and then increase significantly into 2012 as we approach final implementation of mandatory SEF trading of standardized derivatives. A firm time for mandatory SEF trading on the most standardized swaps will be instrumental for the market to achieve its full potential.

In conclusion, Jefferies believes that implementation of Title VII reforms will unless full market forces held in check by entrenched business models and we are ready and eager to compete in the derivatives marketplace.

Thank you for inviting me to testify today and I look forward to any questions the Subcommittee may have.

Chairman REED. Well, thank you, gentlemen, for your excellent testimony.

Senator Toomey and I await momentarily a vote. We have a few minutes to get over there, but I think the best way to proceed would be to allow me to ask a general question to the panel and then recognize Senator Toomey for a question, and then be prepared for an avalanche of written questions because we, unfortunately, will not be able to explore in as much detail at this moment as we wanted to.

But just picking up on something Mr. Bury said about these model contracts that are being developed that you suggest might be literally a choke point for access to the SEFs and the different trading platforms, can you comment further on that in terms of your experience or what you see, and then I will just ask Mr. Merkel and Mr. Thum to comment, too, about this, because I believe some of the major associations are beginning to develop these types of contracts as an alternative to wider use of the SEFs. I think it is an important question. Mr. Bury, please.

Mr. BURY. OK. One example currently that is taking place in the marketplace is an execution agreement on cleared swaps. There has to be some market framework and work flow by which people can start to transact in the cleared environment. So there is currently an industry documentation effort that is underway where people can identify their counterparties and their clearing members for cleared derivatives.

Unfortunately, at this point, we feel that it is overly complex and contains too many complicated built-in credit checking limits that, at the end of the day, somewhat limit people's ability and potential to transact on other venues or engage other counterparties. It is overly complex, and I think if the market shifts and market participants combined with regulators overseeing the effort and helping the process along focus on, I guess, the mandated clearing and acceptance, immediate acceptance of clearing of transactions, then you will not have to rely on a byzantine or complicated documentation framework.

Chairman REED. Thank you.

Mr. Merkel, then Mr. Thum, and thank you.

Mr. MERKEL. I would agree that there are real pressures and forces that work against breaking the status quo and opening up areas for competition, whether it is in clearing, whether it is in execution, whether it is in modes of execution, and I think that those, in many cases, those barriers to changing the status quo are subtle and difficult to discern. I do think there is an issue that I do not think the agencies are as focused on as they might be, and I think that is a considerable problem. There are some protections in Dodd-Frank with respect to this issue, with respect to impartial access, with respect to nondiscriminatory clearing. I have not seen in the regulations that have come out much sensitivity to getting into that in detail.

I have seen in the regulations, to the contrary, there are almost no references to them other than parroting what is in the statute, and what regulations we are seeing that come out in detail are not even part of Dodd-Frank. So I think the regulators are focusing very much on recreating marketplaces or reengineering marketplaces without regard to the effects on liquidity, but spending almost no time looking at trying to foster a competitive landscape.

Chairman REED. Mr. Thum, please.

Mr. THUM. Before you can have mandated SEF trading, you have to have mandated clearing. Before you can have mandated clearing, you have to have the documentation in place. Indeed, ISDA and the FIA are developing standard addendums to overlay over existing futures agreements which the market has in place. Unfortunately, there is no standard futures agreement in the market. Every dealer has its own unique futures agreement. Those futures agreements are developed for futures. They are not developed for swaps.

There are business issues related to the trading of swaps, even clearing swaps, that are unique to swaps that are different from futures that will have to be addressed. There is an overlay that ISDA and the FIA have developed to supplement the existing futures agreement to allow central clearing. Unfortunately, those have to be negotiated bilaterally between every client and every clearinghouse and the existing futures agreement may have to be upgraded, as well. This is an enormous effort.

Certainly, Vanguard is engaged in this at present, but the pipeline is limited in terms of the dealer's ability to digest renegotiating all of their existing futures agreements and have the addendum put in place. This will be a big problem in terms of having a very condensed implementation schedule, which is one of the reasons why I have laid out the sequence of having, first, reporting to informed decision making on block trade size and delays, then have clearing layered in, first through swap dealers and major swap participants, then have clearing laid in for the rest of the market, allowing 18 months to get these documents signed up, and then, finally, SEF trading after that.

Chairman REED. Thank you very much.

Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

Mr. Thum, I would like to follow up with you on this. First of all, I would like to commend you. I think this is a very sensible and very thoughtful proposal that lays out a phased implementation that makes a lot of sense and, frankly, is very helpful. My sense is that there is increasing consensus that there needs to be a phased implementation, but it is not yet clear to me that there is a complete consensus on what the sequence will be, nor necessarily on the overall timing.

So you have touched on several reasons why this is important, the comments you just made about the necessity of getting the documentation in order. As I understand it, your testimony suggests that there could be a negative impact on liquidity if some of the rules, reporting rules, for instance, are not informed by the market data. Could you elaborate a little bit and maybe touch on other aspects, negative aspects that you are concerned about in the marketplace if there is not sufficient time for this implementation to occur?

Mr. THUM. Sure, and I think that is an excellent question. I think that the problem is that, particularly as mandates are layered in place, you could have a situation where those that cross the finish line at an appropriate time consistent with the mandate are allowed to continue to trade swaps, clear and trade swaps, and those that do not get past the finish line, either because their business is not large enough to allow them through the pipeline at the dealer to get the documentation signed up, to have their infrastructure developed, to have all the operational connectivity in place, they will be effectively locked out of the market because of an arbitrary time line that does not take into consideration all the things that need to be done.

In recent CFTC and SEC roundtables, a focus has been on SDRs and gathering information. Once the final rules are in place, the SDRs think it will be three to 6 months before they are ready to be collecting the data and then have the data to allow the commissions and the SEFs to make decisions on block trade size and delays.

So there is a whole sequence of getting the data, having the SDRs set up, getting the data in the door, allowing time for the documentation to get clearing in place, and then once you have the data, analyze the data, assess liquidity, set appropriate block trade sizes and delays so that you can effectively allow for SEF trading. But all these things have to happen and they have to happen in sequence and they have to happen once the rules are finalized.

Senator TOOMEY. And I gather the bottom line is your concern is if it happens on too compressed a schedule, then there are significant participants that could be actually just frozen out of the activity until they are able to get up to compliance, and I suppose, also, the danger of inappropriate rules because they would not be informed by sufficient history.

Mr. THUM. Exactly, and the largest players, some of which were mentioned today in the earlier panel, will probably get to the finish line very quickly.

Senator TOOMEY. Right.

Mr. THUM. But the rest of the market may be left behind. And, of course, the problem—the impacts on liquidity that have been talked about in the various panels will be significant.

Senator TOOMEY. Thank you. Thank you, Mr. Chairman.

Chairman REED. Thank you very much, Senator Toomey.

Gentlemen, thank you for your excellent testimony. We have a vote that is underway, but again, we will, I am sure, be responding, not just Senator Toomey and I, but others with questions for you.

I want to thank all the witnesses for testifying today. We appreciate both the time and effort you made to join us this morning, your excellent testimony. It has been thoughtful. It is also of great assistance to us, and I hope it is of great assistance to the agencies, the SEC and the CFTC, because one of the messages that has been consistent is coordination and accommodation and synchronization of their efforts to regulate the market.

I would also like to submit, without objection, for the record a written statement from the Investment Company Institute, ICI.

If Members of the Committee have their own written statements or additional questions for the witnesses, please submit them no later than close of business next Wednesday. The witnesses' complete written testimony will become part of the hearing record and we are happy to include supporting documentation for the record. We ask that the witnesses respond to any questions within 2 weeks, and note that the record will close after 6 weeks in order for the hearing print to be prepared.

Without further business, I will call the adjournment of the hearing. Thank you.

[Whereupon, at 11:16 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR MIKE CRAPO

Thank you, Mr. Chairman for holding this hearing on the development of Swap Execution Facilities (SEFs).

There are a number of different electronic trading models that could potentially be used for derivatives trading depending upon final rules by the SEC, CFTC, and international regulators.

While Title VII of the Dodd-Frank Act states that the SEC and CFTC shall consult and coordinate to the extent possible for the purposes of assuring regulatory consistency and comparability, the lawyers for the two agencies have not been able to agree what these terms means.

We should not then be surprised when the two agencies propose inconsistent approaches to the same rule sets. For the Swap Execution Facility rules, the SEC approach is more principles-based and is in general far less prescriptive than that of the CFTC.

While the Dodd-Frank Act missed a great opportunity to merge the SEC and CFTC and stop the bifurcation of the futures and securities markets we should continue to push for more coordination and consistent rules.

Swap Execution Facilities are likely going to dually register with the two agencies and it makes a lot of sense for the two regimes to be consistent.

While I applaud the SEC for taking a more flexible approach relative to CFTC, both agencies need to make their rules more accommodative of the different types of SEFs to provide maximum choice in trade execution to market participants.

Under the CFTC SEF version, the proposed rule requires swap users to request prices from no fewer than five dealers at a time.

This is generating a lot of controversy from the end user community which argues it may ultimately serve to unnecessarily disadvantage end users by limiting their ability to choose the appropriate number of counterparties and mode of execution in the way they deem most efficient and effective to hedge their commercial risk.

Since the Dodd-Frank Act stipulates that transactions required to be cleared must also be executed on a SEF or designated contract market there is significant interplay between the clearing, trading, and the definition of block trades.

According to the end users, this could create a problem for some less liquid trades that could be suitable for clearing, but not for trade execution.

I have also been advised that the SEC's SEF approach is more consistent with what the Europeans are looking at but have not acted upon.

If we want to find a common international framework in order to avoid regulatory arbitrage and avoid competitive disadvantages we need to provide greater coordination and harmonization to get the rules right rather than rushing them through.

PREPARED STATEMENT OF KEVIN MCPARTLAND

DIRECTOR OF FIXED INCOME RESEARCH, TABB GROUP

JUNE 29, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for inviting me today to discuss progress and concerns surrounding the creation of swap execution facilities.

I'm Kevin McPartland, a Principal and the Director of Fixed Income Research at TABB Group. TABB Group is a strategic research and advisory firm focused exclusively on the institutional capital markets. Our clients span the entire investment landscape including investment banks, pension plans, mutual funds, hedge funds, high frequency traders, FCMs, exchanges, and clearinghouses. We also operate TabbFORUM.com, a peer-to-peer community site where top level industry executives share thought leadership on important issues affecting the global capital markets.

In order for this new market structure to be successful, swap execution facilities must be given broad latitude in defining and implementing their business models—this includes, but is not limited to, the mechanisms used for trading and the risk profiles of their members. This will promote the innovation and competition that has made the U.S. capital markets the envy of the world.

It is also critical that the mechanisms to move trades quickly and easily from execution to clearing are well defined. If market participants worry that the trade they have just executed on a SEF might later in the day be canceled due to a clearinghouse rejection, confidence in the entire market model will erode quickly, and severely limiting the transparency and systemic risk reduction Dodd-Frank was intended to improve.

New Market Structure

Despite these open concerns, industry sentiment toward the creation of swap execution facilities has turned positive. Based on a TABB Group poll published in April 2011, of more than 140 market participants, 87 percent believe the creation of swap execution facilities will ultimately be good for the swaps market. Of course, everyone defines "good" differently—good for liquidity, for transparency, for profits. Regardless, this demonstrates how the market's view that nearly every business model can—and most will—be adapted to work under the proposed SEF rules.

That being said, no solution will satisfy all market participants—nor should it. Regulators should not try to appease everyone in the market but instead focus their efforts on creating a set of rules that work.

To finalize the new swaps-market rules, regulators can either attempt to fit these products into old structures (such as a futures structure), or develop new mechanisms to manage these products. TABB Group believes regulators should look toward the new rather than wrap a new product in an old package. To that end, we are all presented with the rare opportunity to build up this market from scratch in such a way that it will function effectively for farmers who need to hedge crop prices and global financial institutions working to keep the world's economy flowing.

The exchange model was created over 200 years ago long before electronic trading and high-speed market data. Today we're creating a new 21st-century market, but why would a paradigm from the 1800s make sense as a starting point? With little legacy legislation, rules can be written based on what we know now, not based on the structures developed in 1934 via the Securities and Exchange Act.

Trading Style and Membership Requirements

In order to develop the most suitable market structure for swaps, we must provide swap execution facilities with the freedom to utilize trading styles and different business models, ensuring every market participant has the most efficient access to liquidity possible.

Firstly, SEFs should not be driven to a particular trading model. Despite the inclusion of the Request for Quote model in proposals from the CFTC and SEC, regulators are keen to have swaps trade through an order book with continuous two-sided quotes.

TABB Group research shows that order-book trading will emerge naturally—81 percent believe we will have continuous order book trading of vanilla interest rate swaps within 2 years of SEF rule implementation. However, the existence of an electronic order book does not guarantee liquidity nor that market participants will trade there.

For example, of the roughly 300,000 contracts available for trading in the electronic U.S. equity options market, only 100 of those make up about 70 percent of the volume. The rest are seen as so illiquid that it is often easier to trade OTC with a broker rather than try and execute that same contract on the screen. Furthermore, despite the market's electronic nature, TABB Group research shows that in 2010 as much as 97 percent of all options trading volume generated by asset managers was done over the phone.

Second, we should encourage SEFs to set membership requirements to encourage a variety of liquidity pools. The U.S. equity market presents a good example. Thirteen registered exchanges and another 55 alternative execution venues exist to trade U.S. equities for a total of sixty-eight. Why? Because different market participants trade in different ways and have different needs. Some like to trade in large size, some small; some are very concerned about price while others are more concerned about getting a trade done quickly. Because of this, the equity market responded with new venues to meet those needs.

Although the equities market is very retail focused and the swaps market is purely institutional, a similar dynamic exists. The trading style and needs of a mutual fund are very different from those of a major dealer or a hedge fund. We therefore should encourage swap execution facilities to develop business models that help all market participants, and allow SEFs to compete with each other for whichever client base they chose to serve. This means allowing SEFs to not only define the method of trading, but requirements for entry.

For example, if you were willing to pay the membership fee, a restaurant supply store would be willing to sell you food for your family in the same bulk sizes they provide for restaurants. But since most American families do not need to buy food in bulk, we choose instead to shop at a local supermarket. The price per unit might be higher, but it is a more suitable way to shop for a family of four. Although the analogy might appear flippant, it explains why loosely defined tiers must still exist for trading swaps.

In the current market, a smaller player cannot trade in the interdealer market even if they had the capital and desire. In the new market, as long as a trading firm meets the requirements set forth by the SEF, they will be—and should be—allowed in to trade. The important point to note is that setting membership requirements for SEFs is not exclusionary, but instead intended to help market participants trade in the most suitable environment possible.

Clearing

Open access to clearing will play a huge role in the success or failure of all SEFs. It is central clearing, not the SEF construct itself, that will allow easier access to trading and new market participants to enter. But a clearinghouse providing only the ability to accept SEF executed trades is not enough.

SEFs are intent on providing click-to-trade functionality, that when you accept a price on the screen with a click of the mouse, whether in an order book or via a request for quote, the trade is done. However, a trade is not done until it is accepted for clearing—something the SEFs have little if any control over. That raises the question: can a SEF ensure a trade will be accepted for clearing before it allows the trade to execute? And even if it can, is that its responsibility?

Either way, clearing certainty is crucial to the success of SEFs. If market participants worry that the trade they have just executed on a SEF might later in the day be canceled due to a clearinghouse rejection, confidence in the entire market model will erode quickly and limit severely the transparency and systemic risk reduction Dodd-Frank was intended to improve. It is critical that a mechanism be put in place to formalize this process, ensuring the market can have full faith in the trades they execute on a SEF.

Size of the Market and Open Issues

There has been considerable speculation as to the number of SEFs that will exist. The wildest number I've heard is 100 which is simply unrealistic. If the U.S. equities market has 68 venues and the U.S. futures market has 3 main players, the swaps market will fall somewhere in the middle.

Our research shows also that nearly 60 percent of market participants believe the ideal number of SEFs per asset class is three to four, resulting in 15 to 20 SEFs covering interest rates, credit, FX, commodities, and equities. There will be many more than that to start but not 100—our list at TABB Group shows as many as 40 firms that plan to apply—but 87 percent of our study participants believe that SEF consolidation will begin 2 years or less from the date of rule implementation.

Timing

Rulewriting delays at the CFTC and SEC are unfortunate but necessary. The financial services industry is ready to move ahead to the next chapter, but it is more important that these rules are written properly rather than in haste. Despite the fact that so much uncertainty remains, the industry is moving ahead with preparations for SEF trading, central clearing, trade reporting and the myriad of other new requirements.

We are now in the pre-SEF era. Business models and technology are being finalized, but most SEFs are "registration-ready" and trade flow is beginning to pick up on the screen as most everyone has accepted that these changes are inevitable. Tradeweb, a trading platform set to register as a SEF, tells us their trading volume is up 47 percent from last year. We see this level of growth happening with several of the existing platforms. Even if trading mandates don't take effect until the fourth quarter of 2012—a timeframe that seems more realistic—the change is so enormous for most swaps traders that getting started now should present just enough time to make the switch.

Winners and losers, however, will not be chosen until after regulatory mandates are in place. Too many market participants still exist and see little economic incentive to shift, in addition to those new market participants waiting in the wings. But even still, working together, regulators and the industry have made significant progress during the past year, clarifying the view of what the post- Dodd-Frank world of swaps trading will look like.

As rules are finalized, it is critical that while putting in place necessary oversight, new OTC derivatives rules encourage the innovation and competition that have made the U.S. capital markets the most envied in the world.

Thank you.

PREPARED STATEMENT OF NEAL B. BRADY

CHIEF EXECUTIVE OFFICER, ERIS EXCHANGE, LLC

JUNE 29, 2011

TESTIMONY
OF
NEAL B. BRADY
CHIEF EXECUTIVE OFFICER
ERIS EXCHANGE, LLC
BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

JUNE 29, 2011

Chairman Reed, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to testify on the implementation of Title VII of the Dodd-Frank Wall Street Reform and Customer Protection Act (P.L. 111-203, July 21, 2010) ("Dodd-Frank Act" or "DFA"), specifically the development of swap execution facilities ("SEFs") under the Dodd-Frank Act. I am Neal Brady, Chief Executive Officer of Eris Exchange, LLC ("Eris Exchange" or "Exchange").

Eris Exchange is an electronic futures exchange that began offering the trading of an interest rate swap futures contract in July 2010 in response to the Dodd-Frank Act. Since its inception in July 2010, Eris Exchange has traded over $33 billion in notional value of its interest rate swap futures contract (the "Contract" or the "Eris Interest Rate Swap Futures Contract"). Eris Exchange's Contract is cleared at the Chicago Mercantile Exchange, Inc. ("CME Clearing"), a Derivatives Clearing Organization registered with the Commission.

As an initial matter, it is important to note that Eris Exchange is not a SEF. Eris Exchange filed an application with the U.S. Commodity Futures Trading Commission ("Commission" or "CFTC") on April 18, 2011 to be designated as a contract market (a "Designated Contract Market" or "DCM"). A DCM is the traditional exchange - a board of trade - on which futures contracts have been traded for over a hundred years.[1] Eris Exchange anticipates that it will be a DCM on or before October 18, 2011. As a DCM, Eris Exchange will be permitted to list both traditional financial futures, such as its current Contract, as well as, swaps subject to the Dodd-Frank Act. As such, Eris Exchange will satisfy the Dodd-Frank execution mandate and will compete with SEFs in the cleared interest rate swap space. Eris Exchange has made the business decision to register as a DCM for several reasons, including the ability to offer futures contracts, high capital efficiencies of trading futures through margin offsets, and open access. Therefore, Eris Exchange is uniquely positioned to provide testimony on the experience of a start-up exchange formed in response to the unprecedented regulatory evolution currently underway.[2]

Eris Exchange's testimony is organized to provide the Committee with the following:

- Background on Eris Exchange;
- The Exchange's insights into how principles-based regulation can serve to incentivize SEFs and DCMs to accomplish the goals of the Dodd-Frank Act;
- The Exchange's belief that the industry is in a state of readiness to trade and clear swaps and only requires clear dates for implementation of clearing and trading mandates;
- Arguments that have been made in the industry recently related to perceived operational impediments to SEFs and how these concerns have already been solved for in the futures industry model; and,

[1] Eris Exchange currently operates as an Exempt Board of Trade ("EBOT") subject to the jurisdiction of the Commission. The Dodd-Frank Act eliminates EBOTs from the Commodity Exchange Act, therefore, Eris Exchange has applied to become a DCM.

[2] Eris Exchange has previously filed the following comment letters with the Commission, which are available at Eris Exchange's website: http://www.erisfutures.com: Comments on Governance dated September 29, 2010; Ownership and Governance Comment Letter dated January 28, 2011; DCM Comment Letter dated February 22, 2011; SEF Comment Letter dated March 8, 2011; and, Rulemaking Mosaic Comment Letter dated June 3, 2011.

- Areas of the Commission's proposed rulemakings that threaten the accomplishment of the goals of the Dodd-Frank Act.

I. BACKGROUND ON ERIS EXCHANGE

Eris Exchange was founded by five major independent liquidity providers: Chicago Trading Company; DRW Trading; GETCO; Infinium Capital Management; and, Nico Trading. The Founders are principal trading firms that trade across a wide range of asset classes and have significant experience in the equity and futures markets.

The Founders created Eris Exchange to increase access to traditional over-the-counter ("OTC") markets that are migrating to centrally-cleared trading venues (i.e., SEFs and DCMs) as a result of the Dodd-Frank Act. Traditionally the OTC interest rate swaps market has had a closed system of one-to-one bilateral transactions or one-to-one request-for-quotes ("RFQs"). This is due to historical market structure issues, as well as, the need for the sell-side (i.e., swap dealers) to hedge the risk assumed from engaging in transactions. The OTC interest rate swaps market has historically included high barriers to entry that effectively prevented the emergence of independent liquidity providers. Recognizing the need for additional participants in the OTC interest rate swaps market and the value those participants could add to price discovery and liquidity, Eris Exchange was created as an open venue for all market participants to trade the Eris Interest Rate Swap Futures Contract.

Eris Exchange's initial product offering is due, in part, to the regulatory certainty that has existed for decades with financial futures contracts and the benefits a futures product offers participants, such as execution and clearing certainty and margin offsets with traditional financial futures. The Eris Interest Rate Swap Futures Contract embeds all of the economics of a standard OTC interest rate swap into a single futures price. The Contract is independently marked-to-market and settled every day based on data from the overall interest rate market. The Contract does not have periodic cash flows like standard OTC swaps, but replicates the economics of accrued and expected cash flows in the futures price, resulting in cash transfers through the daily variation margin process. In other words, Eris Exchange has "futurized" an interest rate swap.

II. PRINCIPLES-BASED REGULATION WILL INCENTIVIZE SEFs AND DCMs TO ACCOMPLISH THE GOALS OF THE DODD-FRANK ACT

Eris Exchange supports the overall goals of the Dodd-Frank Act of reducing systemic risk and bringing greater transparency to the OTC markets. Eris Exchange commends Congress on passing the Dodd-Frank Act and commends the Commission on the unprecedented amount of work that has been completed since the Dodd-Frank Act was signed into law by President Barack Obama on July 21, 2010. As the eve of the first year anniversary of Dodd-Frank draws close and the impacts of the financial crisis are still being felt by the American Public three years after the financial crisis was at its peak, we are at a critical junction where the implementation of the Dodd-Frank Act will either accomplish its objectives of reducing systemic risk and promoting transparency or will fail unjustifiably through dilution and delay.

As this Committee examines the development of SEFs under the Dodd-Frank Act and oversees the activities of the Commission as it moves to finalize rules, the Committee's focus must be on the overall goals of the Dodd-Frank Act: the reduction of systemic risk and the promotion of transparency. These goals can be achieved through principles-based regulation by the Commission. At the onset, it should be noted that "principles-based" does not mean "not regulated." Principles-based means the Commission provides concepts for compliance with the Act, while permitting the regulated entities the flexibility to comply. Principles-based regulation is the incentive that will allow SEFs and DCMs to develop in the new Dodd-Frank marketplace.

Principles-based regulation "works" as demonstrated by the fact that the futures industry performed flawlessly during the financial crisis. The futures markets were able to respond to the risks being posed by the financial crisis in terms of offering market participants the ability to manage risk, the stability of clearing a transaction immediately upon execution on a regulated exchange, and the ability to quickly liquidate positions.

III. The Market Is In A "State Of Readiness" For Dodd-Frank Implementation: Clearing, Trading, Reporting

As an exchange, Eris Exchange is a proponent of the futures model for clearing and trading, meaning once a trade is executed, it is cleared by its DCO, CME Clearing. Eris Exchange's core belief is that market participants, and ultimately the American Public, benefit from markets that are transparent, open and competitive. Eris Exchange agrees with Chairman Gensler's recent comment that: "The more transparent a marketplace is, the more liquid it is for standardized instruments, the more competitive it is and the lower the costs for hedgers, borrowers and, ultimately, their customers." Remarks by Chairman Gary Gensler, Bringing Oversight to the Swaps Market, International Finance Corporation's 13th Annual Global Private Equity Conference, Washington, DC (May 11, 2011).

In less than a year, Eris Exchange developed a proprietary trading platform, established a clearing relationship with CME Clearing, processed actual trades, engaged State Street Bank as a technology partner for its central limit order book, and prepared and filed a DCM application. Eris Exchange is an example of a quick-to-market model for bringing transparency to the marketplace. In short, it can be done, especially where there is certainty in the regulatory environment.

While Eris Exchange understands that the mandates of the Dodd-Frank Act cannot be implemented overnight, Eris Exchange believes that clearing houses, execution entities, data repositories, and market participants are ready for implementation, particularly in highly liquid and standardized swaps. This state of readiness is not due to prescriptive regulations, but rather to the principles that have been laid down in the time leading up to and upon the enactment of the Dodd-Frank Act. Eris Exchange believes that the Commission should not deviate from these principles and impose hard and fast rules that will only result in these entities going back to the drawing board to comply and advocating for additional delay.

In order to achieve the goals of the Dodd-Frank Act, Eris Exchange respectfully requests that this Committee urge the Commission to combine a principles-based approach with a timeline with clear dates for implementation, including voluntary compliance in the short term, and hard dates for the clearing mandate and the execution mandate. The market will only fully implement Dodd-Frank when it is clearly mandated to do so. A clear timeline is the regulatory incentive that will facilitate the further development of SEFs and DCMs.

In announcing a timetable, one of the most market-based and competition-friendly actions that the CFTC can take is to implement the execution mandate soon after the clearing mandate. By mandating execution and ensuring open access to all clearing venues, regulators will foster true competition in swaps and create a level playing field for the emergence of new entrants and technology-driven innovation. If, on the other hand, there is a significant lag between the clearing and execution mandates, incumbent firms will be heavily motivated to direct clearing to their preferred clearing venue, and will transact on closed platforms dominated by incumbent firms. Such a time lag runs the risk of severely constraining the ability of new entrants to effectively compete in the execution of cleared swaps.

Eris Exchange believes that the Commission should capitalize upon the industry's lead and provide hard dates for implementation with an agenda that finalizes all rules by December 31, 2011 and phases in compliance with the rules throughout 2012. Eris Exchange proposes a timeline that focuses first on swaps that DCOs already clear as "swaps subject to clearing." Standard interest rate swaps provide a very good and appropriate starting point given that DCOs already clear these products, the market is very large, and the product is very standardized and highly liquid.

Given the state-of-readiness in the industry, Eris Exchange believes that multiple SEFs should be provisionally registered during late 2011, provided they file a complete application, and these SEFs would be ready and willing to make the swap "available for trading." Since many of the likely SEF entities are already "open for business," the first quarter of 2012 should be a period of voluntary compliance to "test the pipes" and resolve issues prior to implementing the clearing and execution mandate. The clearing and trading mandate for interest rate swaps could then be effective in the second quarter of 2012 for swap dealers and the largest major swap participants. During the remainder of the year, additional participants, such as smaller major swap participants and financial entities, should be phased in and subject to the mandate. Eris Exchange believes that Swap Data Repositories should be phased in simultaneously with the clearing and trading mandates, first with voluntary compliance and then with mandatory compliance. While Swap Data Depositories will be a convenient "one stop shop" for the housing of regulatory data, the data held in SDRs will also be readily available at the DCOs, and the DCOs have every financial and business interest to track and manage this data carefully. The implementation of SDRs should therefore not be a dependency for implementing either the clearing or the trading mandates.

While Eris Exchange and the industry are in a state-of-readiness for Dodd-Frank Act implementation, there are several arguments heard in the industry today that are aimed at slowing down the implementation of the Dodd-Frank Act. Specifically, concerns have been raised that the documentation required for market participants to execute and clear swaps is so extensive that it will require untold hours of negotiation and impose burdensome legal costs on customers. This is an exaggerated concern. The futures documentation structure provides a model that should be utilized as a baseline for documentation in the cleared swaps market. In the futures model, there is no need for each user to enter into ISDAs with every other user. For example, to trade on Eris Exchange, a participant and a participant's clearing firm need only enter into a single agreement totaling two pages, one time.

In addition, the concept of "fails" has been frequently discussed, meaning that upon execution, the market participant still has risk that the trade will not clear due to the fact that the counterparty may have insufficient credit. The futures industry and Eris Exchange solve for this by having pre-trade credit checks with a clearing firm, so there is no risk of rejection at the clearinghouse. Also, in the futures model the risk of executing brokers is covered by such broker's primary clearing firm. Thus, at every point in the execution chain, a clearing member stands behind the trade.

Another argument heard today in the industry is that it is impossible to trade interest rate swaps in an open, electronic order book and therefore the traditional OTC execution model must be maintained. Eris Exchange provides concrete evidence that this argument is flawed. Today, Eris Exchange has a live, open, anonymous, electronic central limit order book offering trading for standard maturities of interest rate swap futures. Clearing firms guarantee each order and monitor risk using credit-controls that are built centrally into our trading platform. Eris

Exchange has submitted a screen shot of the Eris Exchange central limit order book, which shows live bids and offers on our screen that are fully transactable and for which users receive instant confirmations of cleared trades with the click of a mouse.

Further, it's worth noting that in the futures industry, the migration from pit-based trading to screen-based trading unleashed a tremendous wave of innovation in which the U.S. derivatives industry emerged as a world leader. If regulators announce a clear timeline and apply the proper incentives, the implementation of Dodd-Frank has the potential to spur a similar technological revolution that will deliver on the real benefits of the legislation-- bringing greater transparency and a wider variety of counterparties into the swaps market, and thereby reducing systemic risk.

IV. Eris Exchange Demonstrates that the Dodd-Frank Goals Are Achievable in a Principles-Based Regulatory Environment

As noted above, Eris Exchange is an EBOT subject to the jurisdiction of the Commission. The Dodd-Frank Act eliminates EBOTs from the Commodity Exchange Act, therefore, on April 18, 2011, Eris Exchange applied to become a DCM. Eris Exchange, then, is a product of the principles-based regulation of the Commodity Futures Modernization Act ("CFMA") making the transition to the new Dodd-Frank world.

The CFMA recognized a need for the development of innovative markets for certain products and participants without a heavily prescriptive regulatory regime. Indeed, even as to DCMs, the CFMA and Commission's rules defined the regulatory scope through Core Principles that provided guidance to DCMs. The CFMA emphasized the self-regulatory obligations of DCMs to comply with the Core Principles and the Act. It is under this framework that Eris Exchange was created as an EBOT and has applied to become a DCM.

Eris Exchange answers the call of the Dodd-Frank Act by providing an open and competitive market and a product that is transparently traded and subject to central counterparty clearing. Eris Exchange has accomplished these objectives under a principles-based regime. In order to preserve the principles-based environment, Eris Exchange respectfully suggests that Congress and this Committee, in its examination of the Commission's proposed and final rulemakings, request that the Commission review its proposed rules and determine where prescriptive rules are absolutely necessary to address systemic risk. In short, the more prescriptive the rules, the more likely the effectiveness of the Dodd-Frank Act will be limited through unintended consequences, calls for delay, and ultimately litigation over the rules.

V. THREATS TO A PRINCIPLES-BASED REGULATORY ENVIRONMENT MUST BE REMOVED FROM THE COMMISSION'S PROPOSALS

The 85% Centralized Market Requirement Threatens Established Market Structure and Innovation

The principles-based regulatory environment has been reinforced, but also threatened, by several of the Commission's proposed rules. In particular, the Committee should be aware of the "Minimum Centralized Market Trading Percentage Requirement" (the "85% Centralized Market Requirement"). The 85% Centralized Market Requirement poses the greatest threat to disrupting the DCM framework that has worked well in the past. *See* 75 FR 80572, 80588. The 85% Centralized Market Requirement will result in forcing futures contracts that historically have been traded on a DCM to either delist from a DCM or "transform" from a futures contract into a swap that is then transferred to a SEF.[3] The 85% Centralized Market Requirement will have the consequence of changing the definition or criteria of a futures contract. This definitional change

[3] The 85% Centralized Market Requirement for a DCM offering the trading of a swap also has implications for the block trading of swaps on a DCM. The SEF Proposal allows greater flexibility for block trades. While the DCM Proposal states that a DCM should follow the block trading rules applicable to SEFs, the swaps on a DCM are still subject to the 85% Centralized Market Requirement.

will, for the first time in Commission history, impose a liquidity requirement on futures contracts. This liquidity requirement will deter new product and market innovation, disrupt markets that have functioned well in the past, and limit the ability of opaque markets to evolve to transparent trading venues. Specifically, the 85% Centralized Market Requirement will harm a well-functioning market structure by limiting the ability of market participants to engage in block trades and exchange of futures for related positions that serve legitimate commercial needs. The result is that the Commission may force a certain futures contract to become a swap, which seems to be a result contrary to the clear language of the Dodd-Frank Act, which specifically excludes futures from the definition of "swap." *See* Section 721(a)(47) of the DFA.

Eris Exchange is not alone in its opposition to the 85% Centralized Market Requirement. Indeed, all DCMs that filed a comment letter, and many others, are opposed to this rule. Recently, several DCMs filed a joint letter with the Commission in opposition to the 85% Centralized Market Requirement.[4] Clearly, the Commission must listen to its constituents and eliminate this proposal.

Restrictions on Ownership Will Preclude the Entrance of Additional SEFs and DCMs into the Marketplace

The Commission proposed a 20% limit on the voting equity or voting power than any single member of a DCM or SEF may own or control. This 20% limit is consistent with limits on ownership of securities exchanges. The Commission, however, did not propose aggregate

[4] *See* Letter from CME Group, NYSE Liffe US, Kansas City Board of Trade, Eris Exchange, GreenX, Minneapolis Grain Exchange, CBOE Futures Exchange to the Commission dated June 3, 2011.

caps on ownership of DCMs or SEFs by any group of entities, such as Enumerated Entities.[5]

The U.S. Department of Justice ("DOJ") expressed concern that the Commission's proposed rule does not include aggregate ownership caps on DCMs and SEFs. Eris Exchange believes that imposing an aggregate ownership cap on a broadly defined group of Enumerated Entities would be counterproductive. The definition of Enumerated Entity encompasses more than just the major derivatives dealers. It also includes all swaps dealers, which under the Dodd-Frank Act includes any person who holds itself out as a dealer in swaps, makes a market in swaps or regularly enters into swaps with counterparties as an ordinary course of business for its own account. Thus, liquidity providers, such as the Founders, would likely be swap dealers if they provide liquidity in the swaps market. For this reason, Eris Exchange does not agree with the view that the Enumerated Entities as a group likely share very similar incentives to limit access and to otherwise insulate themselves from competition.

Eris Exchange does not agree that limiting Enumerated Entities from owning in the aggregate more than 40% of a DCM or SEF would protect competition. In fact, because Enumerated Entities include all swap dealers, it would preclude new liquidity providers in the swaps market – who would be swap dealers – from establishing new trading venues.

As the Commission recognizes, Enumerated Entities are the most likely source of funding for new DCMs and SEFs and the Commission indicated that "the benefits of sustained competition between new DCMs and SEFs outweigh the incremental benefit of better governance through limitations on the aggregate influence of the enumerated entities." Eris

[5] Enumerated Entities are defined as: (1) a bank holding company with total consolidated assets of $50 billion or more; (2) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (3) an affiliate of such bank holding company or nonbank financial company; (4) a swap dealer; (5) a major swap participant; and (6) an associated person of a swap dealer or major swap participant. See 75 Fed. Reg. 63732-01, 63750 (October 18, 2010) (proposing § 39.25(b)(1)(ii)).

Exchange agrees with this analysis by the Commission and views itself as an example of the type of new exchange that can provide competition. For this reason, Eris Exchange believes that aggregate caps on ownership on DCMs and SEFs by a broadly defined category of Enumerated Entities would reduce the likelihood that new swaps trading venues with a broad group of liquidity providers would be established.

In addition, any increase over the proposed thirty-five percent public director board composition requirement for DCMs or SEFs would also serve to preclude the creation of new trading venues. An initial strategic investor in an emerging marketplace, that is already highly competitive, would demand some control over the initial direction of the exchange in order to preserve its investment. This restriction would deter qualified investors from committing capital to start-up SEFs and DCMs. In addition, with the other aspects of the Commission's proposal on governance, the thirty-five percent public director requirement would temper any undue influence of the directors. The proposed voting equity and board composition requirements, combined with open access to trading and clearing, provide a foundation for competition.

VI. CONCLUSION

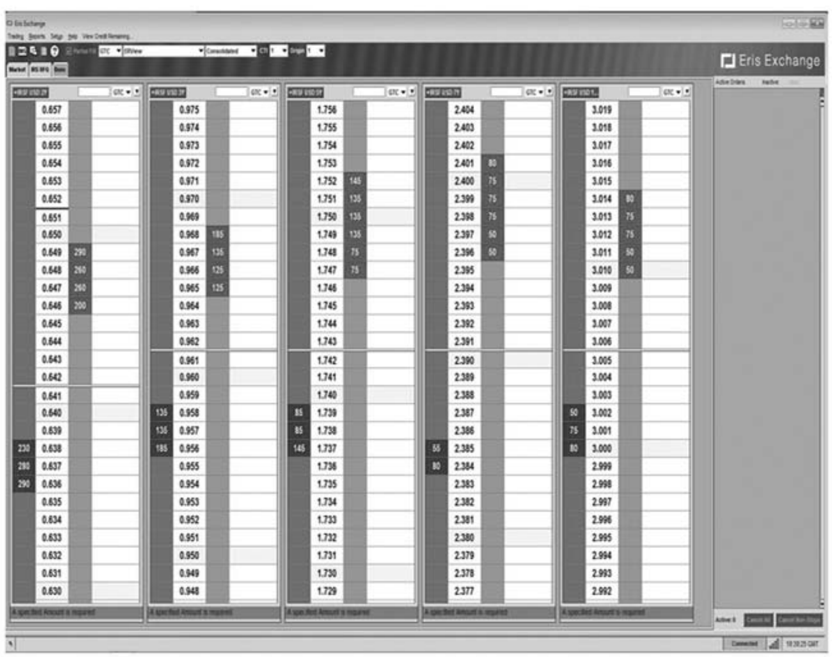
Eris Exchange appreciates the opportunity to comment on this matter. Eris Exchange is fully operational today for trading and clearing of interest rate swap futures, and our product and trading protocols embody the guiding principles of the Dodd-Frank Act. In implementing the Dodd-Frank Act, we believe the Commission has a historic opportunity to improve the efficiency of the swaps market, providing great benefit to customers, and ultimately reduce transaction costs while also reducing systemic risk.

The key to successful implementation, however, is to move forward quickly with a principles-based approach that fosters innovation and incentivizes DCMs, SEFs and DCOs to deliver concrete benefits to customers of swaps. The market is ready for the migration to cleared swaps trading, and is waiting only for clear direction and a roadmap from the Commission. To that end, Eris Exchange respectfully suggests that the Committee and Congress should encourage the Commission to set forth clear effective dates for the clearing and trading mandates.

Thank you again for inviting Eris Exchange to testify on these important matters.

APPENDIX:

ERIS EXCHANGE, LLC CENTRAL LIMIT ORDER BOOK, JUNE 2011



PREPARED STATEMENT OF BEN MACDONALD

GLOBAL HEAD OF FIXED INCOME, BLOOMBERG, L.P.

JUNE 29, 2011

My name is Ben Macdonald and I am the Global Head of Fixed Income for Bloomberg L.P., a privately held independent limited partnership headquartered in New York City. Bloomberg is not owned by any swap market participants and does not itself engage in trading of swap instruments on a proprietary basis. Our customer base for our information and news services, market analytics and data services, and for our platforms for electronic trading and processing of over-the-counter (OTC) derivatives is evenly distributed among buy-side and sell-side entities. We serve the entire spectrum of the financial market and, being independent, we do not have a bias toward nor are we beholden to any particular element of the market.

Bloomberg's core business is the delivery of analytics and data on approximately 5 million financial instruments, as well as information and news on almost every publicly traded company through the Bloomberg Professional service.[1] More than 300,000 professionals in the business and financial community around the world are connected via Bloomberg's proprietary network. Over 17,000 individuals trade on our system across all fixed income product lines alone, with over 50,000 trading tickets a day coming over that network. Virtually all major central banks and virtually all investment institutions, commercial banks, Government agencies and money managers with a regional or global presence are users of the Bloomberg Professional service, giving Bloomberg extraordinary global reach to all relevant financial institutions that might be involved in swap trading.

I lead Bloomberg's team of professionals dedicated to establishing a registered Swaps Execution Facility (SEF) and Security-Based Swaps Execution Facility (SB–SEF) under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As the largest independent player in the market in terms of electronic trading and processing of OTC derivatives, Bloomberg has an extensive suite of capabilities, experience, technical expertise, infrastructure, connectivity, and community of customers that uniquely position our fIrm to provide unbiased, independent intermediary SEF and SB–SEF services to both the buy-side and the sell-side in the domestic and international swaps market. All major swaps dealers utilize our platform. Over 600 firms use Bloomberg's existing platform to trade interest rate swaps and credit default swaps. We provide connectivity for both the buy-side and the sell-side to multiple clearinghouses. We facilitate exchange-traded as well as voice brokered swaps on our system.

Bloomberg fully supports the creation of the regulated swaps marketplace envisioned by Dodd-Frank. We believe that the Dodd-Frank mandatory clearing and reporting requirements will significantly mitigate systemic risk, promote standardization, and enhance transparency. We enthusiastically anticipate being a robust and capable competitor in the SEF and SB–SEF markets, and we believe our participation as an independently owned firm will bring innovation, reliability, efficiency, transparency, and reduction of systemic risk to the markets.

Bloomberg's Existing Electronic Swaps Platforms: Experience and Innovative Leadership

Our views on the subject of SEF[2] regulation are significantly informed by our long and successful experience derived from our existing OTC swaps trading platforms. We believe that body of expertise and experience provides Bloomberg the opportunity to engage the new world of SEF registration and operation from a considerable position of strength. Our current OTC derivatives trading platforms were built on the idea of adding transparency to the market by creating electronic functions that streamline trading in swaps and provide efficient, competitive access to swaps pricing, all of which aligns very well with the goals of Title VII of Dodd-Frank.

Bloomberg's current "single-dealer" and "multidealer" derivatives trading tools allow multiple participants to view and trade swaps with multiple dealers. In Bloomberg's single-dealer page system, enabled participants are readily able to view different dealer pages (simultaneously if preferred) that display the price and volume at which each dealer has indicated it will trade. After reviewing the displayed prices a participant can then request to execute against a single-dealer page's dis-

[1] Bloomberg employs over 12,900 employees around the world, including more than 2,300 news and multimedia professionals at 146 bureaus in 72 countries, making up one of the world's largest news organizations.

[2] Our reference to "SEFs" in this testimony is intended to include SB–SEFs as well unless otherwise indicated.

played price with the understanding that the dealer can accept, counter, or reject execution. Multidealer pages display a "composite price" reflecting the general market based on participating dealers' respective price submissions. After reviewing the displayed "composite price" a participant can request specific prices from 3 dealers. The participant then has a limited time to accept or reject a trade with any of the dealers. Under both models, Bloomberg provides real-time trade reporting to warehouses, data repositories, and clearing venues.

Bloomberg also has hosted various "request for quote" (RFQ) systems for OTC derivatives for the past 5 years. These RFQ systems allow entities seeking liquidity to secure bids and offers from particular market participants they would like to engage in a transaction. Our Bloomberg Bond Trader System, a competitive multidealer RFQ platform for U.S. and foreign government securities, has been active for more than 13 years. We are confident that these very successful RFQ models provide directly relevant experience and are the proper conceptual paradigm for establishing a SEF under Dodd-Frank.

In addition to operating a very robust RFQ system, we also operate our "AllQ" system that shows market participants on one screen the stack of liquidity reflected in the range of streaming bids and offers from multiple dealers in the market. Users can perform their price discovery, and then click and trade with their dealer of choice.

Both our RFQ and our AllQ systems empower properly enabled market participants to hit on executable bids and offers, or engage in electronic negotiation with counterparties on indicative bids. Our experience and success with our RFQ and AllQ platforms provide us confidence that we will be able to satisfy the operational requirements established by Dodd-Frank for SEF registration. We intend to be prepared to begin SEF operations on the implementation date of the relevant SEF regulations issued by Commodity Futures Regulatory Commission (CFTC) and the Securities Exchange Commission (SEC), provided that the two regulators create synchronized rules governing trading protocols, board composition and financial reporting.

Responses to the Committee's Specific Areas of Inquiry

Bloomberg most certainly supports Dodd-Frank's call for the emergence of SEF-style trading, increased mandatory clearing and post-trade transparency through reporting. In particular, Bloomberg is very supportive of the Federal regulators providing clear and specific rules for clearing, and post-trade transparency, which together serve as the most significant tools for reducing systemic risk and attaining a reformed, financially sound derivatives marketplace that benefits market participants and the Nation as a whole. The systemic risk threats that arose in 2008–2009 were associated with insufficient clearing and post-trade transparency and were not the result of execution failures. Indeed, market participants know very well what they want and need regarding fair and efficient execution on electronic platforms. Sophisticated market participants do not really need or want Federal regulators micro-managing execution protocols; no one should expect that market participants will necessarily want to trade the way the Federal Government prefers that they trade. It is also not the proper role of the Federal regulators to go to extravagant lengths to define the most favorable terms of execution for trading by sophisticated investors. Rather, while it is clearly a very important function, what is incumbent on Federal regulators is only to insure that the market is fair and competitive and that participants themselves have enough information to assess whether they know that they are getting a fair price.

The risk that Federal regulators run in micromanaging execution protocols is that they will increase the direct cost of trading—with no compensating benefit to customers—and impose significant constraints and indirect costs that incentivize market participants to revert to forms of trading that evade the excessive regulation and those costs. It will not be difficult for market participants to find wholly lawful ways to conduct their trading in non-SEF environments, including taking their trading to foreign jurisdictions where the U.S. rules do not apply.

Consequently, we do not believe that the same degree of regulation warranted for clearing and post-trade reporting is desirable from a public policy perspective with regard to trade execution protocols. Rather, in providing rules on trading protocols, Federal regulators should specifically avoid over-regulation and imposing "one size fits all" mandates, but should instead use a principles-based approach which encourages flexibility by SEFs that will maximize their innovation, competition and responsiveness to the needs of the market. Failure to invest SEFs with the ability to employ flexibility in their trade execution protocols actually jeopardizes the realization of the public policy objectives that Dodd-Frank seeks to attain.

In his letter of invitation to this hearing, Chairman Reed outlined six specific areas of inquiry of interest to the Subcommittee. In response, Bloomberg offers the following views:

Question 1: What is the status of industry readiness for trading on SEFs? What in your view is the timeline for the movement of substantial volumes of derivatives activity onto SEFs? What, if any, documentation is necessary for market participants to migrate their trading activity onto SEFs?

There are different degrees of readiness for trading on SEFs among market participants and among products. Some market participants, including banks, hedge funds, insurers, and other sophisticated entities, are very eager and ready to begin trading on SEFs; other market participants will require more time to prepare themselves for SEF trading. The same is true with regard to the "readiness" of different products for SEF trading. The volume and liquidity of what are viewed as "plain vanilla" interest rate swaps, credit default and currency swaps make them prime candidates for early movement to SEF trading; but other products will take more time. The CFTC and SEC are currently engaged in the process of determining how to properly phase in participants and products as part of their effort to effectively sequence the implementation of the range of Dodd-Frank regulations and we believe the relative "readiness" of market participants and products ought to play a significant role in that phasing/sequencing determination.

It is also worth noting however that if "readiness" is viewed in the context of capability to conduct the type of electronic trading envisioned for SEFs, Bloomberg in specific and the financial industry in general are very ready to commence SEF trading. The volume of electronic trading over the past decade has been enormous and the infrastructure to create the connectivity for SEF trading certainly exists. We have witnessed ever increasing migration of trading to a variety of electronic trading formats. Bloomberg itself has witnessed an accelerated use of our electronic platforms since the passage of Dodd-Frank a year ago. That said, SEF-style trading which entails multilateral trading and direct routing to clearinghouses remains rare since most current OTC swaps trading is bilateral and not submitted for clearing.

We further note that if "readiness" is viewed from the perspective of the state of the legal framework for the clearing and increased transparency imposed by Dodd-Frank for SEF trading, there is considerable work still ahead for the industry. Clearing and transparency are certainly priority objectives of Dodd-Frank's SEF regime as means to mitigate systemic risk, but those rules have not yet been articulated in final form by the CFTC and SEC. We expect those rules, once promulgated in final form, will be novel in many ways and costly, and it will take time for market participants to do all the things necessary to accommodate those rules in terms of legal documentation, installation of technology, and other critical responses. With regard to documentation alone, there is a significant number of necessary items that will require time for negotiation between interested parties and for careful drafting by lawyers.[3] Ultimately, how much swaps trading moves to SEF platforms will be influenced by the complexity of the agencies' final rules and the cost of those rules for clearing, documentation, reporting and the like that must be borne by SEFs and their customers. The objective of those rules should be to minimize their cost and complexity in order to incentivize optimal movement of swaps trading to properly regulated SEF platforms and to minimize avoidance of those newly regulated SEF platforms.

Question 2: How do you expect the open access requirements for clearinghouses to impact the development of SEFs? Are there any obstacles to clearinghouses meeting this open and nondiscriminatory access requirement?

Bloomberg has been successful in securing access to various clearinghouses for its existing OTC trading platforms. While mandatory swaps clearing as envisioned by Dodd-Frank is not completely worked out in all regards, we are cautiously optimistic that in a reasonable time we will have no significant problems with clearing for trades on our registered SEF platforms. We believe that our connectivity to a range of clearinghouses will provide end users a desirable choice in where to clear their swaps, which effectuates one of the objectives of Dodd-Frank which was to empower

[3] While not an exhaustive list, the large and complex range of documents that need to be negotiated and drafted include: derivative clearing organization agreements, swaps data repository agreements and protocols, platform participant agreements and end user agreements, independent service vendor agreements, and information sharing agreements with corresponding SEFs and Designated Contract Markets trading swaps to effectuate compliance relating to position limits and manipulation issues. In addition, SEFs will have to draft participant rulebooks, compliance manuals, connectivity agreements, antimoney laundering documentation, and numerous other vital documents.

end users in that regard. It should be emphasized however that the cost and uncertainty of the rules on clearing swaps under the Dodd-Frank regime could be impediments to the proliferation of SEFs.

Question 3: What regulatory and market-based incentives can facilitate the development and success of SEFs?

Bloomberg believes that the Federal regulatory agencies should focus on creating well-articulated rules for clearing and post-trade market transparency, and to the maximum extent possible allow SEFs flexibility in fashioning their own trading protocols. In our judgment the most important incentive that can facilitate the development and success of SEFs is to give the SEFs significant latitude on the trading protocols they use. Maximizing the flexibility for SEFs to devise and implement their trading protocols will encourage innovation, competition and market responsiveness. In contrast, prescribing trading protocols by regulation will inhibit attainment of those public policy objectives and decrease overall SEF participation and market liquidity. It is noteworthy that the swaps market evolved to give swaps users highly customizable products that allowed them to meet specific investment objectives. Losing that tradition of flexibility to overly constrictive trading requirements would be destructive to the goal of encouraging a vibrant, competitive, and innovative SEF market.

Question 4: Do any barriers currently exist in the derivatives market that would inhibit the entrance of additional SEFs into the marketplace? Are there ways to mitigate those barriers, and how would those changes impact the derivatives market?

Given the technology afforded by the Internet and connectivity, technological barriers to entry are relatively low. However, we do perceive several elements of the Dodd-Frank regime that could create barriers to entry in terms of increased risk and cost for entities considering registering as SEFs.

Micromanagement and Overregulation of Trading Protocols

Central clearing ensures that there is sufficient capacity for the market to absorb losses within its own structure and trade reporting promotes price transparency which ensures price fairness. Both of these elements of Dodd Frank are beneficial to the market and ultimately to the individual investor and taxpayer. But trying to regulate with specificity the trading protocols may discourage the use of SEFs, and undermine the benefits that Dodd-Frank was designed to deliver through SEFs by reintroducing risk and removing liquidity. For example, mandating the use of a central limit order book would encourage the style of algorithmic and speculative trading that were at the center of the equities flash crash in 2010. Such an event would not be possible with today's fixed income trading structure.

Similarly, mandating the number of dealers that can participate in an RFQ may actually create liquidity risk because investors will only be able to trade if there are the mandated minimum number of market participants available. The proposed minimum requirement of having 5 respondent dealers for a SEF's RFQ platform reduces the end user's ability to achieve best execution because they will be forced to advertise their activities to a broader set of market participants than they may want. This problem is particularly acute with regard to block trades. The same can be said of imposing mandatory protocols that would require a block trade to interact with any resting interests on a SEF.

Liquidity providers responding to a block trade RFQ need to factor in the size of the trade when quoting a price. Imposing a trading protocol that could materially alter the size of a block trade would inject uncertainty for the liquidity provider responding to an RFQ. Rather, liquidity providers should be given the option of interacting with resting bids (*i.e.,* standing bids posted on platforms without reference to any particular RFQ) if it is consistent with their trading strategy and best execution, and SEFs should be allowed to offer that flexibility to the market.[4] Similarly, liquidity seekers tend to vary their strategies as to the number of liquidity providers they include in an RFQ. Their strategies typically depend on the particular instrument (and its relative liquidity), the direction (long or short), and the size of the transaction they are seeking to execute. Liquidity seekers should have the flexibility in any given transaction to identify the optimal number of liquidity providers from which to seek bids.

---

[4] So too, forcing a minimum number of dealers into the RFQ process will likely increase cost with no compensating offset or benefit. We observe that the SEC's proposed SBSEF rules do not mandate transmission of an RFQ to a minimum or maximum number of liquidity providers.

Nor should SEFs be limited to one model or methodology in disseminating composite indicative quotes to the market. Developing a meaningful composite is a complex process involving intricate proprietary algorithms and each SEF has a compelling reason to develop a composite indicative quote that represents the most accurate reflection of the markets that meets participant needs and expectations for accuracy. A SEF that offers a composite that is consistently "away" from the actual market will quickly be disciplined and marginalized by participants' disuse of that SEF.

There are other examples of the wisdom and value of allowing SEFs flexibility at the trading protocol level but the above illustrations convey the point that overly prescriptive mandates in this area are both unnecessary to the desirable functioning of SEFs and will effectively create barriers to SEFs coming into the market.

Cost of Compliance

The greatest current cost of compliance lies in the different rules promulgated by the CFTC and SEC. While Dodd-Frank requires these two agencies to coordinate their approach, it remains to be seen whether they will sufficiently do so in their respective final regulations. If they fail to do so, the result will be that to operate as both a SEF and a SB–SEF an entity will be compelled to create two separate companies to trade what in essence are the same type instruments. This not only affects each potential SEF and SBSEF but also their clients, many of whom use the same individual traders to trade both instruments types. The effective doubling of costs due to the inability of the two regulatory bodies to sufficiently coordinate their rules would not only be regrettable but creates a barrier to entry for the independent firms wishing to become SEFs and SBSEFs. It is fair to ask whether that may only auger concentration in the SEF space and a "too-big-to-fail" situation for the remaining SEF's in the marketplace, which is exactly the opposite of what Congress intended when they included the idea of SEFs in Dodd-Frank.

The creation of a complex set of overly detailed rules to manage trading protocols within the SEF market will generate significant regulatory compliance costs for SEFs which will have to be borne ultimately by the end users of the SEF platforms. Such costs can be mitigated by allowing the SEFs maximum flexibility to create their own trading protocols.

Costs can further be reduced by providing a robust opportunity for SEFs to contract with third party service providers for such things as market surveillance, trade practice surveillance, real-time market monitoring, investigations of possible rule violations and disciplinary actions. In contracting for such services—while maintaining Dodd-Frank's requirement that SEFs retain full, ultimate responsibility for decision making involving those functions—SEFs can avoid the capital and operational costs of creating the infrastructure of those functions for themselves internally and thereby reduce both the cost of entry into the SEF market and the cost of ongoing SEF operations.

Beyond being allowed to use the expertise of third party service providers, SEFs also should be permitted to rely on the regulation and oversight of market participants and swap products by swaps clearinghouses rather than have to replicate essentially the same activity at the SEF level. For example, if a clearinghouse accepts a market participant for clearing purposes or accepts a swap for clearing, the SEF should be permitted to rely on that assessment for Core Principle compliance purposes regarding its obligation to establish that the market participant is an eligible swap participant or that the swap is not susceptible of manipulation under the SEF regulatory regime.

Governance Constrictions

Dodd-Frank requires the agencies to minimize opportunity for conflicts of interest in the governance of SEFs which would allow anticompetitive behavior injurious to other market participants. Both the CFTC and SEC have proposed regimes for mitigating conflicts of interests through ownership limitations and structural governance requirements. These rules were written to address risks arising from a situation where a SEF would be owned and controlled by other market participants who would be tempted to set SEF policy to advance their own interests and to the detriment of other market participants and the market in general.

Requiring all SEFs to meet these ownership and governance constrictions is a serious and unnecessary barrier to entry in the case of SEFs whose ownership structure does not present the risks that Dodd-Frank's conflict of interest provisions were intended to prevent.[5] Bloomberg is an independently owned entity, meaning that other market participants do not have an ownership interest in the company. We are not beholden to either buy side or sell side interests. There is no public policy purpose in requiring Bloomberg or any other an independently owned firm to jump through unnecessary hoops and contort its governance to prescribed forms designed to prevent conflicts of interest risks that demonstrably do not exist due to their independent ownership structure and business model. We believe that where a SEF is not owned by its customer-members or other market participants and where the SEF can demonstrate a sufficient mitigation of legitimate potential conflicts of interests the agencies should permit that SEF an exemption from the governance restrictions which were designed to redress conflicts arising from cases where market participants own and control the SEF. Such an exemption would mitigate prospects that the governance rules would serve as an unproductive barrier to entry for independently owned SEFs who can bring to the market the competition that Dodd-Frank sought to generate in swaps trading.

Extraterritoriality and International Harmonization

The swaps marketplace is a global business. A large percentage of transactions on Bloomberg's swap platforms involve non-U.S. banks and other foreign institutions. An entity seeking to register as a SEF desires to have consistent standards applicable to both SEFs and market participants across different jurisdictions. Without such coordination a SEF may be put in the untenable position of enforcing rules against certain participants that are inconsistent, or worse, conflicting with foreign rules. Moreover, without harmonized and consistent standards a SEF could be required to have one set of rules for U.S. participants and another set of rules for non-U.S. participants, with a further set of transaction-level rules based on the counterparties or underlying instruments. The resulting legal uncertainty associated with an uneven playing field and regulatory arbitrage can be a significant disincentive to becoming a SEF, to maximizing a SEF's availability to market participants, or to the scope of the products offered for trading on the SEF.

Question 5: How do you expect the SEF marketplace to develop over time? How many SEFs would you imagine operating in the United States and around the world 5, 10, and 20 years after full implementation of the derivatives title?

The existence of multiple SEFs will at least initially be a function of asset classes (credit, interest rates, currencies, commodities, equities) and market function (liquidity seekers versus liquidity providers). Initially, one can fairly assume that there may well be a larger number of SEFs in each asset class and market function, which over time may yield to consolidation based on the gravitation of the pool of liquidity to certain SEFs based on their superior performance and their more favorable system functionality.

Having said that, predicting the number of SEFs globally is complicated by the fact that outside the U.S. there are no specific regimes to regulate swaps as SEFs are envisioned by Dodd-Frank. It can be said that in terms of U.S.-registered SEFs, the number of SEFs will be inversely proportional to the number and strength of barriers to entry. In this regard, the problem we foresee with unnecessary and unwise limitations on the flexibility of SEFs to determine their own trading protocols will be paramount. To the extent that SEFs are homogenous, required to fit a specific "one size fits all" regime on trading protocols, they will increasingly resemble cookie cutter utilities, providing less innovation and responsiveness to market participants' evolving needs for those SEFs in the market and less incentive for new SEFs to enter the market to compete with incumbent SEFs. But the more flexible SEFs can be with their trading protocols the more incentive there will be for all SEFs to distinguish themselves with innovation, vigorous competition and increasingly more cost effective functionality for the market—all of which enhances the incentive for SEFs to come into the market in greater numbers.

Question 6: What policy considerations, if any, should Congress or the regulators consider in order to better support the successful development of SEFs?

The key public policy element we would suggest to Congress and the Federal regulators to better support successful development of SEFs relates to flexibility of trading protocols. There is little disagreement that clearing and transparency are

[5] While SEC has suggested they may require universal compliance with these conflict/governance rules even for independent entities, that view is not required by Dodd-Frank, nor is that interpretation a requirement written into the CFTC's proposed rules. Beside being irrational because independent entities do not present the governance conflict risks the rules were designed to address, applying those rules would add unnecessary cost to independent entities operations without any countervailing public policy benefit.

good for the market and will reduce systemic risk created by large concentrations of derivative positions. However, overly prescriptive methods of execution threaten market liquidity and create risks of unintended adverse consequences such as incentivizing trading that avoids SEFs (dark pools) and flight to less regulated foreign markets. Enabling SEFs to rely on aspects of the DCO compliance regime that would otherwise replicate compliance obligations imposed on SEFs would reduce SEF costs and incentivize SEFs to focus productively on their trading protocols which will maximize innovation, competition and market responsiveness.

Conclusion

SEFs represent a very valuable opportunity to achieve the reduction of systemic risk and transparency objectives of Dodd-Frank. Overly constrictive swaps trading rules will seriously diminish the contribution that SEFs can make to achieving those laudable public policy objectives. It is imperative, especially at the outset of the Dodd-Frank regime, that the regulations pertaining to SEFs do not mitigate the promise SEFs represent to achieve those legislative objectives which will keep the U.S. markets at the vanguard of international finance. In our view, this means the Federal regulators should not approach regulation of trade execution protocols from the same conceptual perspective as may be required for clearing and post-trade transparency. SEFs need operational flexibility at the trade execution level and without it one should not expect a robust emergence of SEFs or the ongoing innovation, competition and customer responsiveness they can bring to the market.

On behalf of Bloomberg, I want to extend my appreciation for having this opportunity to appear before the Subcommittee to express our views. We are happy to be of further assistance to you as you continue your deliberations on these extremely important issues.

PREPARED STATEMENT OF JAMES CAWLEY

CHIEF EXECUTIVE OFFICER, JAVELIN CAPITAL MARKETS

JUNE 29, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, my name is James Cawley. I am Chief Executive Officer of Javelin Capital Markets, an electronic execution venue of OTC derivatives that will register as a SEF (or "Swaps Execution Facility") under the Dodd Frank Act.

I am also here to represent the interests of the Swaps & Derivatives Market Association or "SDMA," which is comprised of several independent derivatives dealers and clearing brokers, some of whom are the largest in the world.

Thank you for inviting me to testify today.

Without a doubt, it is mission critical that central clearing, increased transparency, and broader liquidity is properly achieved under the Dodd-Frank Act for the OTC derivative markets. Toward that goal, it is important that SEFs be allowed to properly function and compete with each other whereby Congress and the Regulators ensure that such organizations and their various execution models be neither discriminated against, nor be penalized by trade workflow or documentation efforts that show preference for one SEF over another.

Only by access to a fair, level, and open playing field, will SEFs be properly able to play their part in the lessening of systemic risk, to which the derivative marketplace contributed during the global financial crisis of 2008.

Product Eligibility and Open Access

With regard to product eligibility to clearing, clearinghouses should recognize that the fair majority of interest rate and credit derivative products do qualify for clearing.

Regulators should be mindful to ensure that clearinghouses do not favor acceptance of certain products that have built in trade restrictions that impede open access or customer choice.

While intellectual property rights may protect innovation in the short term, with regard to certain swap products or indices, they may restrict trade and liquidity in the long term. Market participants should be allowed to trade such products to meet their investor or hedging objectives. Intellectual property rights for such products should adapt with the post Dodd-Frank market place where anonymous and transparent markets flourish.

Regulators should work with these IP holders to both ensure that their rights are properly protected, and the prudential need of the broader market is also protected.

Open Access to Clearinghouses

With regard to SEF access to clearinghouses, clearinghouses and their constituent clearing members should do as the act requires—accept trades on an "execution blind" basis. DCOs should not discriminate against trades simply because they or they shareholders dislike the method in which such trades occur.

Clearinghouses should refrain from using their SEF sign-up documentation as a vehicle to restrict trade. As a precondition to access, clearinghouses should not require that SEFs sign "noncompete" clauses, such that a clearinghouse's other businesses—be it execution based or not—are inappropriately protected from outside competition.

Likewise clearing firms should not require that SEF's contract with them to restrict the rights or privileges of end users, as a precondition to SEF-clearinghouse connectivity. Such requirements serve no prudential role with regard to risk mitigation and run contrary to the open access provisions of the Dodd-Frank Act.

Real Time Trade Acceptance

Clearinghouses should not require that a SEF purposefully engage in a trade workflow that adds latency or creates unnecessary steps in the settlement process.

Instead, clearinghouses and their constituent clearing firms should draw from their own proven and well tested experience in listed derivatives. They should accept trades symmetrically and in "real time."

Immediate acceptance of swaps trades into clearing is critical to accomplishing the goals of the Dodd-Frank Act to reduce systemic risk, increase trade integrity, and promote market stability.

Settlement uncertainty, caused by time delays between the point of trade execution and the point of trade acceptance into clearing, can destroy investor confidence in the cleared OTC derivatives markets.

As the CFTC has correctly asserted such a time delay or "trade latency," (which in the bilateral swaps markets can be as long as a week) directly constrains liquidity, financial certainty, and increases risk. [1]

Clearinghouses and their clearing members should do as the regulators have required, accept trades into clearing immediately upon execution on a SEF.

Execution Documentation Efforts

Regulators should be wary of certain incumbent efforts that claim to bring execution certainty through documentation. Such documentation sets in place workflow that clearly favors RFQ (Request for Quote) execution models over exchange like central limit order books.

Such documentation denies the customer the right to trade anonymously with multiple counterparties, because under such a workflow, the dealer counterparty requires the identity of the customer be known before a trade occurs.

This is not the case with documentation and workflow requirements in the cleared derivatives markets of futures and options. In those markets, buyers and sellers trade in multiple trade venues where trade integrity, counterparty anonymity and optimal liquidity is assured through access to multiple counterparties.

Such restrictive workflow and documentation should be seen for what it is—nothing more than a transparent attempt to limit customer choice, restrict trade, and drain liquidity.

Conclusion

In conclusion, the role of the Swap Execution Facility with regard to lessening systemic risk should not be understated.

To fulfill the SEF's role in fostering greater liquidity and transparency, Congress and the regulators should continue to be proactive and protect the market against Dodd-Frank implementation "chokepoints." They should continue to ensure that all SEFs have fair and open access to clearing and the marketplace.

PREPARED STATEMENT OF WILLIAM THUM

PRINCIPAL AND SENIOR DERIVATIVES COUNSEL, THE VANGUARD GROUP, INC.

JUNE 29, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for having me here today. My name is William Thum and I am a Principal and Senior Derivatives Counsel at Vanguard.

---

[1] P. 13101. (Federal Register, Volume 76, No. 47, 3/10/11).

Headquartered in Valley Forge, Pennsylvania, Vanguard is one of the world's largest mutual fund firms. We offer more than 170 U.S. mutual funds with combined assets of approximately $1.7 trillion. We serve nearly 10 million shareholders including American retirees, workers, families, and businesses whose objectives include saving for retirement, for children's education, or for a downpayment on a house or a car.

Vanguard's mutual funds are subject to a comprehensive regulatory regime and are regulated under four Federal securities laws. As a part of the prudent management of our mutual funds, we enter into swaps to achieve a number of benefits for our shareholders including hedging portfolio risk, lowering transaction costs, and achieving more favorable execution compared to traditional investments.

Vanguard has been supportive of the Dodd-Frank Act's mandate to bring regulation to the derivatives markets to identify and mitigate potential sources of systemic risk.

Vanguard supports a phased implementation schedule over an 18- to 24-month period following rule finalization based on the following objectives:

- prioritizing risk reduction over changes to trading practices and market transparency;
- prioritizing data reporting to inform future rulemaking related to trading practices and market transparency (to minimize a negative impact on liquidity);
- harmonizing overlapping U.S. and global regulatory efforts; and
- allowing immediate voluntary access for all party types to the new platforms with mandated compliance to apply initially to swap dealers and major swap participants.

In view of the time needed to digest the final rules and develop industry infrastructure; to implement complex operational connections required for reporting, clearing, and exchange trading; to educate clients on the changes and obtain their consent to trade in the new paradigm; and to negotiate new trading agreements across all trading relationships, Vanguard supports the following implementation schedule:

- 6 months from final rules: Swap Data Repositories, Derivatives Clearing Organizations, SEFs, and middleware providers must complete the build-out of their respective infrastructures.
- 6 to 12 months from final rules: All participants should voluntarily engage in reporting, clearing, and trading platforms.
- 12 months from final rules: All participants should be mandated to report all swaps involving all parties. Dealers and major swap participants should be mandated to clear the first list of "standardized swaps."
- 18 months from final rules: All participants should be mandated to clear the first list of "standardized swaps." SEFs and Commissions can analyze SDR swap data for liquidity across trade types to make informed SEF trading mandates, block trade size and reporting delays. Dealers and major swap participants should be mandated to trade the first list of "standardized swaps" "made available for trading" on SEFs.
- 2 years from final rules: All participants should be mandated to trade the first list of "standardized swaps" "made available for trading" on SEFs with delayed public reporting of block trades based on historical relative liquidity.

The need for a phased implementation schedule is supported by recent studies which have identified significant differences in liquidity between the swaps and futures markets. While futures trading is characterized by high volumes of a limited range of trade types of small sizes and limited duration, the swaps market has an almost unlimited range of trade types of much larger sizes with a much longer duration. Swaps liquidity varies dramatically with high liquidity for 2-year U.S. dollar interest rate swaps, and much smaller liquidity in credit default swaps on emerging market corporate entities.

The potential negative consequences related to liquidity are best demonstrated by the impact of the premature public reporting of large-sized block trades. When quoting a price for a block trade, dealers typically charge a slight premium to the then current market price for a similar trade of a more liquid size. Once the block trade is executed, the Swap Dealer executes one or more liquid-sized mirror trades at current market prices to lay-off its position and to flatten its market exposure.

The premature public dissemination of block trade details will provide the market with advance knowledge of the dealer's imminent trading and is therefore likely to move the market against the dealer. Fund investors will ultimately have to bear either the increased price of relevant trades, or the increased costs of establishing positions using multiple trades of liquid sizes.

The CFTC's proposed test for block trade size, and the CFTC and SEC's proposed time delay for the public dissemination of block trade data are too conservative and are likely to have a serious negative impact on liquidity. Particularly as such proposals address market transparency and not market risk, the more prudent approach would be to make informed decisions based on a thorough analysis of market data with larger block trade sizes and more prompt public reporting for the most liquid products and smaller sizes and delayed reporting for less liquid products.

In addition to the need for SDRs, DCOs, and SEFs to establish fully functional platforms, the central clearing of derivatives will require the negotiation (and possibly renegotiation) of all existing master trading agreements to establish the required clearing relationships for swaps. While ISDA and the Futures Industry Association are working on a standard form of addendum for cleared swaps to add to parties' futures agreements, as there is no market standard form of futures agreement, and existing futures agreements may not address a number of key business issues related to the clearing of swaps, the futures agreement itself is likely to require significant renegotiation.

Even if the larger market participants can promptly work through the process with dealers, many smaller participants could effectively be cut out of the swaps market altogether if the documentation process is not completed ahead of the clearing deadline.

There are a number of other significant issues related to the SEF trading mandates proposed by each of the CFTC and SEC which I am happy to discuss in the question and answer period. Such issues include the CFTC's proposed requirement for "Requests for Quotes" to be distributed to a minimum of 5 dealers, the CFTC's and SEC's mandate for participants to "take into account" or to "interact with" other resting bids and offers (including indicative bids and offers), the CFTC's requirement for there to be a "15 second delay" involving crossing trades, and the need for harmonization across the CFTC and SEC rulemaking to avoid unnecessary complexities.

Thank you for this opportunity to share our views with the Subcommittee and we will be pleased to serve as a resource for the Members with respect to the swaps rulemaking exercise.

PREPARED STATEMENT OF STEPHEN MERKEL

EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, BGC PARTNERS, INC.

JUNE 29, 2011

Chairman Reed, Ranking Member Corker, and Members of the Subcommittee, thank you for providing this opportunity to participate in today's hearing.

My name is Stephen Merkel. I am the Executive Vice President, General Counsel, and Secretary for BGC Partners, a leading global interdealer broker of over the counter financial products. [1] BGC Partners was created in August 2004, when Cantor Fitzgerald separated its interdealer brokerage business to create BGC Partners. We are a leading global intermediary to the wholesale financial markets, specializing in the brokering of a broad range of financial products including fixed income, rates, foreign exchange, equities, equity derivatives, credit derivatives, futures, and structured product markets.

I am testifying today in my capacity as the Chairman of the Wholesale Markets Brokers' Association, Americas (the "WMBAA"), an independent industry body whose membership includes the largest North American interdealer brokers: my firm, BGC Partners, as well as GFI Group, ICAP, Tradition and Tullett-Prebon. [2]

---

[1] BGC Partners, Inc. (NASDAQ: BGCP) (*www.bgcpartners.com*) is a leading global intermediary to the wholesale financial markets, specializing in the brokering of a broad range of financial products including fixed income, rates, foreign exchange, equities, equity derivatives, credit derivatives, futures, and structured product markets. BGC offers a full range of brokerage services including price discovery, trade execution, straight through processing and clearing, settlement and access to electronic trading services through its eSpeed, BGC Trader and BGC Pro brands. On April 1, 2008, BGC merged with eSpeed to form a world-class provider of voice and electronic brokerage services in the global marketplace. The combined company is BGC Partners, Inc. Since its separation from Cantor Fitzgerald in 2004, BGC has expanded to 24 offices worldwide with over 1,700 brokers and approximately 2,700 employees. In 2005, BGC merged with Maxcor Financial Group, integrating two leading brokerage firms. This was followed by the acquisitions of ETC Pollak and Aurel in Paris.

[2] The WMBAA is an independent industry body representing the largest interdealer brokers operating in the North American wholesale markets across a broad range of financial products.

I welcome this opportunity to discuss with you the emergence of swap execution facilities (SEFs) under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "DFA"). I hope to share the perspective of the primary intermediaries of over-the-counter (OTC) swaps operating today, both here in the United States and across the globe.

In my written testimony, I plan to cover the following points:

- *Readiness.* In terms of readiness, BGC and its fellow WMBAA member firms are currently fully functional as market intermediaries in the OTC derivatives markets and will be ready to initiate SEF operations on day one. Wholesale brokers are today's central marketplaces in the global swaps markets and, as such, can serve as a prototype for prospective independent and competitive SEFs.
- *Voice and electronic modes of trade execution.* Wholesale brokers are experts in fostering liquidity and transparency in global swaps markets by utilizing trade execution methodologies that feature a hybrid blend of knowledgeable and qualified brokers, as well as sophisticated electronic technology. The CFTC's proposed rules are inconsistent with the statute in the way that they limit how trades are executed, most particularly in how they limit trades that occur utilizing voice or telephonic communication. Such a limitation is inconsistent with the statute's clear language that ensures that SEFs can utilize "any means of interstate commerce." The SEC's proposed rule is much more flexible and consistent with the statute.
- *Block trade size and preserving liquidity and anonymity in the market.* Liquidity in today's swaps markets is fundamentally different than liquidity in futures and equities markets, and the unique characteristics of this liquidity are what naturally determine the optimal mode of market transparency and trade execution. The CFTC's proposal could jeopardize liquidity in the markets by relying on inappropriate factors to determine a block trade. This would harm the ability of investors to manage large positions, impact the ability of counterparties to engage in anonymous price discovery and, ultimately, increase the cost of risk management to end users. The definition of block trade must be based on hard market data to minimize unintended negative consequences.
- *Competition.* It is vital that the rules be consistent with the clear and unambiguous provisions in the statute ensuring that clearinghouses provide SEFs "non-discriminatory access" to clearing. To be consistent with the statute this must include direct and indirect actions that not only inhibit access to clearing, but also actions that would bundle the services of a clearinghouse that operates an execution facility (exchange or SEF), thereby providing favorable treatment to their own affiliates over their independent competitors. Another form of discrimination includes treating differently SEF traded contracts and those traded on exchanges in liquidation. The CFTC's proposed rule needs to be changed to ensure that in liquidation there is identical treatment of the cleared contract regardless of the venue it traded.

Essential Elements That Regulators Need To Get Right Under Title VII

- The final regulations enacted by the Commodity Futures Trading Commission ("CFTC" or "Commission") and Securities and Exchange Commission ("SEC" or "Commission" and, together with the CFTC, the "Commissions") must be consistent with the plain language of Dodd-Frank and allow for multimodes of execution as Congress intended. SEFs must not be restricted from deploying the many varied and beneficial trade execution methodologies and technologies successfully used today to execute swaps transactions.
- There must be harmonization between the CFTC and SEC, as well as consistency in international regulation.
- New regulations must be phased-in appropriately to prevent unnecessary disruption to the markets.
- Regulators must use a flexible approach to SEF registration, permitted modes of trade execution and impartial access. Regulations should support the forma-

The WMBAA and its member firms have developed a set of Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets. Using these Principles as a guide, the WMBAA seeks to work with Congress, regulators, and key public policy makers on future regulation and oversight of institutional markets and their participants. By working with regulators to make wholesale markets more efficient, robust, and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country's capital markets. The five founding members of the WMBAA are BGC Partners; GFI Group; ICAP; Tradition, and Tullett-Prebon. More about the WMBAA can be found at: *www.WMBAA.org.*

tion of a common regulatory organization (CRO) for SEFs to implement and facilitate compliance with the Commissions' rules. The CRO would ensure that a single, consistent standard is applied across multiple SEFs and prevent a "race to the bottom" for rule compliance and enforcement programs.

Background on Wholesale Brokers

In terms of actual operations, WMBAA members provide a marketplace for a relatively small number of sophisticated institutional buyers and sellers of OTC financial products where their trading needs can be matched with other sophisticated counterparties having reciprocal interests in a transparent, yet anonymous, environment. To persons unfamiliar with our business, I often describe interdealer brokers as a virtual trading floor where large financial institutions buy and sell financial products that are not suited to, and therefore rarely traded on, an exchange.

As we sit here today, interdealer brokers are facilitating the execution of hundreds of thousands of OTC trades corresponding to an average of $5 trillion in notional size across the range of foreign exchange, interest rate, U.S. Treasury, credit, equity, and commodity asset classes in both cash and derivative instruments. WMBAA member firms account for over 90 percent of intermediated swaps transactions taking place around the world today.

Wholesale brokers provide highly specialized trade execution services, combining teams of traditional "voice" brokers with sophisticated electronic trading and matching systems. As in virtually every sector of the financial services industry in existence over the past 50 years, wholesale brokers and their dealer clients began connecting with their customers by telephone. As technologies advanced and markets grew larger, more efficient, more diverse and global, these systems have advanced to meet the changing needs of the market. Today, we refer to this integration of voice brokers with electronic brokerage systems as "hybrid brokerage." Wholesale brokers, while providing liquidity for markets and creating an open and transparent environment for trade execution for their market participants, do not operate as single silo and monopolistic "exchanges." Instead, we operate as competing execution venues, where wholesale brokers vie with each other to win their customers' business through better price, provision of superior market information and analysis, deeper liquidity and better service. Our customers include large national and money center banks and investment banks, major industrial firms, integrated energy and major oil companies and utilities.

Increasingly, the efficiencies of the market have inevitably led to a demand for better trading technology. To that end, we develop and deploy sophisticated trade execution and support technology that is tailored to the unique qualities of each specific market. For example, BGC's customers in certain of our more complex, less commoditized markets may choose among utilizing our electronic brokerage platforms to trade a range of fixed income derivatives, interest rate derivatives, foreign exchange options, repurchase agreements and energy derivatives entirely on screen. Alternatively, they can execute the same transaction through instant messaging devices or over the telephone with qualified BGC brokers supported by sophisticated electronic technology. It is important to note that the migration of certain products to electronic execution was not, and has never been, because of a regulatory or legal mandate but simply part of the natural evolution and development of greater market efficiencies in particular markets. Conversely, the persistence of customer preference for trade execution through telephonic communications for certain products, despite the apparent efficiencies associated with electronic trading in other similar products in the same markets, reflects those customers' preference for the unique advantages that "voice" brokers can provide in liquidity formation with respect to less-liquid or more bespoke products.

The critical point is that competition in the marketplace for transaction services has led interdealer brokers to develop highly sophisticated transaction services and technologies that are well tailored to the unique trading characteristics of the broad range of swaps and other financial instruments that trade in the OTC markets today. Unlike futures exchanges, we enjoy no execution monopoly over the products traded by our customers. Therefore, our success depends on making each of our trading methods and systems right for each particular market we serve. From decades of competing for the business of the worlds' largest financial institutions, we can confirm that there is no "one size fits all" method of executing swaps transactions.

Dodd-Frank Impact on Swaps Market Structure: Clearing and Competing Execution

Title VII of Dodd-Frank was an earnest and commendable effort by Congress to reform certain aspects of the OTC swaps market. The DFA's core provisions relating to clearing and trade execution are: (1) replacing bilateral trading where feasible with central counterparty clearing; and (2) requiring that cleared swaps transactions between swaps dealers and major swaps participants be intermediated by qualified and regulated trading facilities, including those operating under the definition of "swap execution facilities" through which "multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce . . . ."[3]

These two operative provisions seek to limit the current market structure where swaps and the underlying counterparty risk may be traded directly between counterparties without the use of trading intermediaries or clearing and to replace it for most transactions with a market structure in which a central clearing facility acts as the single counterparty to each market participant (*i.e.,* buyer to each seller and seller to each buyer) and where those cleared transactions must be traded through SEFs and other intermediaries and not directly between the counterparties.

In enacting these structural changes, DFA wisely rejected the anticompetitive, single silo exchange model of the futures industry, in which clearing and execution are intertwined, thereby giving the exchange an effective execution monopoly over the products that it clears.[4] Rather, by requiring central clearing counterparties to provide nondiscriminatory access to unaffiliated execution facilities, DFA promotes a market structure in which competing SEFs and exchanges will vigorously compete with each other to provide better services at a lower cost in order to win the execution business of sophisticated market participants. In this regard, DFA preserves the best competitive element in the existing swaps landscape: competing wholesale brokers.

BGC and the WMBAA members heartily support Dodd-Frank's twin requirements of clearing and intermediation. Their advocacy of swaps intermediation is fundamental to their business success in fostering liquidity, providing price transparency, developing and deploying sophisticated trading technology tools and systems and operating efficient marketplaces in global markets for swaps and other financial products.

Critical Elements To Get Right

There are many things to get right under DFA. Given that DFA requires all clearable trades to be transacted through an intermediary (either an exchange or a SEF), it is essential that regulators get the following aspects of this new regime right:

1. Permit multimodes of swap execution, consistent with Congressional intent.
2. Ensure harmonization between agencies and foreign regulators.
3. Allow for the appropriate implementation of final rules.
4. Utilize a flexible approach to SEF registration, permitted modes of trade execution, and impartial access.
5. Recognize the important role a common regulatory organization can play in ensuring the integrity of the SEF industry.

1. Permitted Modes of Execution

As previously stated, DFA defines SEFs as utilizing "any means of interstate commerce" to match swaps counterparties. This is an appropriate allowance by Congress, as the optimal means of interaction in particular swaps' markets varies across the swaps landscape. Congress recognized that it was best left to the marketplace to determine the best modes of execution for various swaps and, thereby, foster technological innovation and development. Congress specifically did not choose to impose

[3] *See,* Commodity Exchange Act (CEA) Section 1a(50).

[4] As the Justice Department observed in a 2008 comment letter to the Treasury Department, where a central counterparty clearing facility is affiliated with an execution exchange (such as in the case of U.S. futures), vertical integration has hindered competition in execution platforms that would otherwise have been expected to: result in greater innovation in exchange systems, lower trading fees, reduced ticket size and tighter spreads, leading to increased trading volume and benefits to investors. As noted by the Justice Department, "the control exercised by futures exchanges over clearing services . . . has made it difficult for exchanges to enter and compete." In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. The absence of vertical integration has facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads, and high trading volume. *See,* Comments of the Department of Justice before the Department of the Treasury Review of the Regulatory Structure Associated With Financial Institutions, January 31, 2008. Available at *http://www.justice.gov/atr/public/comments/229911.html.*

a federally mandated "one-size-fits-all" transaction methodology on the regulated swaps market.

As the swaps market has developed, it has naturally taken on different trading, liquidity and counterparty characteristics for its many separate markets. For example, in more liquid swaps markets with more institutional participants, such as certain U.S. Treasury, foreign exchange and energy products, wholesale brokers operate fully interactive electronic trading platforms, where counterparties can view prices and act directly through a trading screen and also conduct a range of pre- and post-trade activities like online price analysis and trade confirmation. These electronic capabilities reduce the need for actual voice-to-voice participant interaction for certain functions, such as negotiation of specific terms, and allow human brokers to focus on providing market intelligence and assistance in the execution process. And yet, even with such technical capabilities, the blend of electronic and voice assisted trading methods still varies for different contracts within the same asset class.

In markets for less commoditized products where liquidity is not continuous, BGC Partners and its competitors provide a range of liquidity fostering methodologies and technologies. These include hybrid modes of: (1) broker work-up methods of broadcasting completed trades and attracting others to "join the trade;" and (2) auction based methods, such as matching and fixing sessions. In other swaps markets, brokers conduct operations that are similar to traditional "open outcry" trading pits where qualified brokers communicate bids and offers to counterparties in real time through a combination of electronic display screens and hundreds of installed, always-open phone lines, as well as through other email and instant messaging technologies. In every case, the technology and methodology used is well calibrated to disseminate customer bids and offers to the widest extent and foster the greatest degree of liquidity for the particular market.

Permitted Use of Voice and Hybrid Trade Execution Platforms

The WMBAA feels strongly that the CFTC's proposed rules regarding SEFs do not reflect the DFA's requirement that SEF transactions can be executed "through any means of interstate commerce." Specifically, in restricting the use of voice-based systems for those clearable trades that must be executed on a SEF, the CFTC has proposed a more restrictive regime than the statute dictates. A rigid implementation of the SEF framework will devastate existing voice and "hybrid" systems that are currently relied upon for liquidity formation in global swaps markets. "Hybrid brokerage," which integrates voice with electronic brokerage systems, should be clearly recognized as an acceptable mode of trade execution for all clearable trades. The combination of traditional "voice" brokers with sophisticated electronic trading and matching systems is necessary to provide liquidity in markets for less commoditized products where liquidity is not continuous. Failure to unambiguously include such systems is not only inconsistent with Dodd-Frank but will severely limit liquidity production for a wide array of transactions. BGC and our fellow WMBAA members are concerned that such a restrictive SEF regime will lead to market disruption and, worse, liquidity constriction with adverse consequences for vital U.S. capital markets.

The WMBAA strongly supports the SEC's interpretation of the SEF definition as it applies to trade execution through any means of interstate commerce, including request for quote systems, order books, auction platforms or voice brokerage trading, because such an approach is consistent with the letter and spirit of the Dodd-Frank Act and ensures flexibility in the permitted modes of execution. The WMBAA believes that this approach should be applied consistently to all trading systems or platforms and will encourage the growth of a competitive marketplace of trade execution facilities.

What determines which blend of hybrid brokerage is adopted by the markets for any given swap product is largely the market liquidity characteristic of that product, whether or not the instrument is cleared. For example, a contract to trade Henry Hub Natural Gas delivered in Summer 2017, though cleared, will generally be insufficiently liquid to trade on a central limit order book. This is true for many cleared products with delivery dates far in the future, where market makers are unwilling to post executable bids and offers in instruments that trade infrequently. In markets where price spreads are wide or trading is infrequent, central limit order books are not conducive to liquidity, but rather may be disruptive to it.

Critically, what determines which blend of hybrid brokerage is adopted by the markets for any given swap product also has little to do with whether the size of a transaction is sufficient or not to be considered a block trade. Block trades concern the size of an order, as opposed to the degree of market liquidity or presence of tight bid-offer spreads. Depending on where block trade thresholds are set, block trades can take place in all markets—from very illiquid markets to highly liquid markets. Yet, central limit order book trade execution generally only works well in markets with deep liquidity, and such liquidity is not always available even within a usually liquid market. For less liquid markets, even nonblock size trades depend on a range of trading methodologies distinct from central limit order book or request for quote systems. For these reasons, hybrid brokerage should be clearly recognized as an acceptable mode of trade execution for all swaps whether "required" or "permitted."

In addition, the regulatory framework for the swaps market must take into consideration the significant differences between the trading of futures on an existing exchange and the trading of swaps on SEF platforms. While it may be appropriate, in certain instances, to look to the futures model as instructive, overreliance on that model will not achieve Congress' goal. Congress explicitly incorporated a SEF alternative to the exchange-trading model, understanding that competitive execution platforms provide a valuable market function. Final rules governing SEFs should reflect Congressional intent and promote the growth of existing competitive, vibrant markets without impeding liquidity formation.

While certain requirements should be mandated during trade execution (*i.e.,* audit trail, trade processing, and reporting), limitations on methodologies used in trade execution should be considered carefully and weighed against potential implications on liquidity formation. A rules regime that is overly prescriptive will reduce the ability for SEFs to match buyers and sellers and restrict trading liquidity, to the detriment of all market participants, including end users.

2. Importance of Harmonization Between U.S. Agencies and Foreign Regulators

While the substance of the proposed requirements for SEF registration and core principles are extremely important, it is equally, if not more, important that the final regulatory frameworks are harmonized between the CFTC and SEC. A failure to achieve harmonization will lead to regulatory arbitrage and unreasonably burden market participants with redundant compliance requirements. As the recent SEC CFTC joint proposed rule recognized, "a Title VII instrument in which the underlying reference of the instrument is a "narrow-based security index" is considered a security-based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (*i.e.,* the index is broad-based), the instrument is considered a swap subject to regulation by the CFTC."[5]

Any discrepancy in the Commissions' regulatory regimes will give market participants incentive to leverage the slight distinctions between these products to benefit from more lenient rules. Dodd-Frank's framework was constructed to encourage the growth of a vibrant, competitive marketplace of regulated SEFs. Final rules should be crafted that encourage the transaction of OTC swaps on these trading systems or platforms, as increased SEF trading will increase liquidity and transparency for market participants and increase the speed and accuracy of trade reporting to swap data repositories (SDRs). Certain provisions relate to these points, such as the permitted methods of trade execution, the scope of market entities granted impartial access to SEFs, the formulation of block trade thresholds and compliance with SEF core principles in a flexible manner that best recognizes the unique characteristics of competitive OTC swaps markets.

Based upon the WMBAA's review of both the SEC and the CFTC's proposed rules, the Commissions should consider the release of further revised proposed rules incorporating comments received for additional review and comment by market participants. This exercise would ensure that the SEC and CFTC have the opportunity to review each of their proposals and integrate appropriate provisions from the proposed rules and comments in order to arrive at more comprehensive regulations. Further, the CFTC and SEC are encouraged to work together to attempt to harmonize their regulatory regimes to the greatest extent possible. While some of the rules will differ as a result of the particular products subject to each agency's jurisdiction, inconsistent rules will make the implementation for SEFs overly burdensome, both in terms of time and resources. As an example, the CFTC and the SEC should adopt one common application form for the registration process. While regulatory review of the application by the two agencies is appropriate, reducing the regulatory burden on applicant SEFs to one common form would allow for a smoother, timelier transition to the new regulatory regime. Because the two proposed registration forms are consistent in many respects, the differences between the two pro-

[5] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818, 29, 845 (May 23, 2011).

posed applications could be easily reconciled to increase regulatory harmonization and increase efficiency.

Similarly, there needs to be a consistent approach with respect to block trades. Not only should the threshold calculations be derived from similar approaches, allowing for tailored thresholds that reflect the trading characteristics of particular products, but the methods of trade execution permitted by the Commissions should both be flexible and within the framework of the SEF definition. U.S. regulations also need to be in harmony with regulations of foreign jurisdictions to avoid driving trading liquidity away from U.S. markets toward markets offering greater flexibility in modes of trade execution. In particular, European regulators have not formally proposed swap execution rules with proscriptive limits on trade execution methodology. We are not aware of any significant regulatory efforts in Europe to mandate electronic execution of cleared swaps by institutional market participants.

In a world of competing regulatory regimes, business naturally flows to the marketplace that has the best regulations—not necessarily the most lenient, but certainly the ones that have the optimal balance of liquidity, execution flexibility and participant protections. U.S. regulations need to be in harmony with regulations from foreign jurisdictions to avoid driving trading liquidity away from U.S. markets toward markets offering greater flexibility in modes of trade execution.

3. Implementation of Final Rules

Compliance Timeline

The timeline for implementation of the final rules is as important as, if not more important than, the substance of the regulations. We recognize and support the fundamental changes to the regulation of the OTC swaps markets resulting from the passage of the Dodd-Frank Act and will commit the necessary resources to diligently meet the new compliance obligations.

However, the CFTC and SEC must recognize that these changes are significant and will result in considerable changes to the operations and complex infrastructure of existing trading systems and platforms. It is necessary that any compliance period or registration deadline provides sufficient opportunity for existing trade execution systems or platforms to modify and test systems, policies and procedures to ensure that its operations are in compliance with final rules. It is very difficult to determine the amount of time needed to ensure compliance with the rules until the final requirements are made available. However, providing market participants with an insufficient time frame for compliance could harm the efficient functioning of the markets if existing entities can no longer operate until they have built the requisite platforms to comply with every measure in final rules.

Appropriate "Phasing" of Final Rules

Based upon the plain language of Dodd-Frank, the mandatory trade execution requirement will become effective at the time that swaps are deemed "clearable" by the appropriate Commission. Accepting the premise that the mandatory trade execution requirement cannot be enforced until there are identified "clearable" swaps and swaps are "made available for trading," the Commissions need to ensure that a functioning and competitive marketplace of registered SEFs exists at the time the first trade is cleared and made available for trading. As such, it is necessary that SEFs be registered with the CFTC or SEC, as applicable, and available to execute transactions at the time that trades begin to be cleared under the new laws. As stated previously, the WMBAA estimates that its members currently account for over 90 percent of interdealer intermediated swaps transactions taking place around the world today. If the SEF registration process is not effectively finalized by the time various swaps are deemed clearable, there could be serious disruptions in the U.S. swaps markets with adverse consequences for broader financial markets.

Furthermore, requiring absolute compliance with final rules within a short time frame is particularly troublesome for likely future SEFs, as such a result may provide DCMs or national securities exchanges with an unfair advantage in attracting trading volume due to their ability to quickly meet the regulatory burdens. Congress distinguished between exchanges and SEFs, intending for competitive trade execution to be made available on both platforms. Congress also recognized the importance of SEFs as distinct from exchanges, noting that a goal of Dodd-Frank is to promote the trading of swaps on SEFs. The phasing in of final rules for both exchanges and SEFs should be done concurrently to ensure that this competitive landscape remains in place under the new regulatory regime.

Not only will implementation of the final rules impact market infrastructure, but the timing in which these rules are implemented could significantly impact U.S. financial markets. As Commissioner Jill Sommers recently remarked before the House Agriculture General Farm Commodities and Risk Management Subcommittee, "a material difference in the timing of rule implementation is likely to occur, which may shift business overseas as the cost of doing business in the U.S. increases and create other opportunities for regulatory arbitrage."[6] If the U.S. regulations are implemented before foreign regulators have established their intended regulatory framework, it could put U.S. markets at a significant disadvantage and might result in depleted liquidity due to regulatory arbitrage opportunities.

As the rulemaking process moves forward, we suggest the following progression of rules be completed:

- First, finalize product definitions. Providing the market with certainty related to the scope of what constitutes a "swap" and "security-based swap" will allow market participants to accurately gauge the impact of the other proposed rules and provide constructive feedback on those rules.
- Second, implement final rules related to real-time reporting for regulatory oversight purposes. The submission of information to SDRs is an activity that takes place in many OTC markets today and will not unduly burden those who must comply with the requirement. Ensuring that the Commissions receive current, accurate market data is a cost-effective method to mitigate systemic risk in the short-term.
- Next, establish block trade thresholds and finalize public reporting rules. The information gathered by SDRs since the implementation of the mandatory trade reporting requirement, along with historical data made available by trade repositories and trade execution facilities, can be used to determine the appropriate threshold levels on a product-by-product basis. At the same time, public reporting rules can be put into place, including an appropriate time delay (that is consistent with European and the other major global market rules) for block trades.
- After the reporting mechanics have been established, the clearing mandate can be implemented. During this step, the Commissions can determine what swaps are "clearable" and subject to the clearing mandate, and clearinghouses can register and begin to operate within the new framework.
- Finally, once swaps are deemed clearable, the mandatory trade execution requirement can be put into place for SEFs and DCMs for those products made available for trading. All clearable swaps will be made available for trading by SEFs, as these trade execution platforms compete to create markets and match counterparties. With the trade execution requirement's implementation, it is imperative that rules for SEFs and DCMs are effective at the same time, as implementing either entity's rules prior to the other will result in an unfair advantage for capturing market share of executable trades simply because they could more quickly meet the regulatory burdens.

Taking adequate time to get the Title VII regulations right will expedite the implementation of the worthy goals of Dodd-Frank: central counterparty clearing and effective trade execution by regulated intermediaries in order to provide end users with more competitive pricing, increased transparency and deeper trading liquidity for their risk management needs.

4. Flexible Approach to SEF Registration, Impartial Access, and Other Areas of Concern

We support a flexible approach to evaluating applicant SEFs. As noted above, Congress recognized and mandated by law trade execution "through any means of interstate commerce," establishing a broad framework that permits multiple modes of swap execution, so long as the proposed mode of execution is capable of satisfying the statutory requirements.

Moreover, any interpretation of the SEF definition must be broad, and any trading system or platform that meets the statutory requirements should be recognized and registered as a SEF. The new regulatory framework should allow any SEF applicant that meets the statutory requirements set forth in Dodd-Frank to be permitted to operate under each Commission's rules in accordance with Dodd-Frank.

BGC and the WMBAA strongly support the SEC's interpretation of the SEF definition as it applies to trade execution through any means of interstate commerce, including request for quote systems, order books, auction platforms or voice brokerage trading, because such an approach is consistent with the letter and spirit of Dodd-Frank and ensures flexibility in the permitted modes of execution. The

---

[6] Statement of Jill E. Sommers before the Subcommittee on General Farm Commodities and Risk Management, House Committee on Agriculture, May 25, 2011, available at *http://agriculture.house.gov/pdf/hearings/Sommers110525.pdf.*

WMBAA believes that this approach should be applied consistently to all trading systems or platforms and will encourage the growth of a competitive marketplace of trade execution facilities.

Further, we are concerned with the CFTC's interpretation of the SEF definition, as it limits the permitted modes of trade execution, specifically restricting the use of voice-based systems to block trades. The SEF definition and corresponding requirements in the CEA, as amended by the Dodd-Frank Act, do not provide any grounds for this approach and will severely impair other markets that rely on voice-based systems (or hybrid systems, which contain a voice component) to create liquidity.

Impartial Access to SEFs

The WMBAA is concerned that the CFTC's proposed mandate that SEFs provide impartial access to independent software vendors (ISVs) is beyond the legal authority in the CEA because it expands the impartial access provision beyond "market participants" to whom access is granted under the statute. Moreover, because SEFs are competitive execution platforms, a requirement to provide impartial access to market information to ISVs who lack the intent to enter into swaps on a trading system or platform will reduce the ability for market participants to benefit from the competitive landscape that provides counterparties with the best possible pricing. Further, given the lack of a definition of what constitutes an ISV and the significant technological investments made by wholesale brokers to provide premiere customer service, the ISV impartial access requirement leaves open the possibility that SEFs could qualify as ISVs in order to seek access to competitors' trading systems or platforms. This possibility would defeat the existing structure of competitive sources of liquidity, to the detriment of market participants, including commercial end users.

The WMBAA also believes the SEC should review its proposed impartial access provisions to ensure that impartial access to the SEF is different for competitor SEFs or national exchanges than for registered security-based swap dealers, major security-based swap participants, brokers or eligible contract participants. Congress clearly intended for the trade execution landscape after the implementation of Dodd-Frank to include multiple competing trade execution venues, and ensuring that competitors cannot access a SEF's trading system or platform furthers competition, to the benefit of the market and all market participants.

Regulations Should Not Favor Execution on Particular Venues

The WMBAA believes that it is critically important that the Commissions' regulations not favor trade execution on exchanges over SEFs. An important part of the Dodd-Frank competitive landscape is that derivatives clearing organizations (DCOs) accept trades from all execution platforms and not advantage certain trading systems or platforms over others.

WBMAA is concerned that certain proposed regulations will frustrate the development of a truly competitive landscape. For instance, one of the CFTC's proposed rules (proposed Regulation 39.13(g)(2)) would require a DCO to use a five-business day liquidation horizon for cleared swaps that are not executed on a designated contract market (DCM), but would permit a DCO to use a one-business day liquidation horizon for all other products that it clears, including swaps that are executed on an affiliated DCM.

The WMBAA believes that this disparity is ill-founded. In the case of two economically identical instruments—one executed on a SEF and one executed on a DCM—the liquidation horizon for each should depend upon liquidity characteristics such as average daily volume, standard deviation of average daily volume and open interest. To require a longer horizon simply because one of the two is traded on a SEF rather than on a DCM is harmful, discriminatory and based upon a flawed understanding of market dynamics. More fundamentally, the WMBAA believes that this disparity is inconsistent with the provisions of Section 2(h)(1)(B) of the Commodity Exchange Act.

The WMBAA also believes that eliminating the disparity described above is consistent with the competitive landscape that Congress intended to establish for SEFs and DCMs. Dodd-Frank is designed to encourage competition between SEFs and DCMs with respect to the trading of swaps, in part by rejecting the "vertical silo" model that has traditionally been employed in the futures markets.

Interim or Temporary SEF Registration

The implementation of any interim or temporary registration relief must be in place for registered trading systems or platforms at the time that swaps are deemed "clearable" by the Commissions to allow such platforms to execute transactions at the time that trades begin to be cleared. Interim or temporary registration relief would be necessary for trading systems or platforms if sequencing of rules first addresses reporting to SDRs and mandatory clearing prior to the mandatory trade execution requirement. The Commission is strongly encouraged to provide prompt provisional registration to existing trade execution intermediaries that intend to register as a SEF and express intent to meet the regulatory requirements within a predetermined time period. To require clearing of swaps through derivatives clearing organizations without the existence of the corresponding competitive trade execution venues risks inconsistent implementation of the Dodd-Frank Act and could have a disruptive impact on market activity and liquidity formation, to the detriment of market participants.

At the same time, a temporary registration regime should ensure that trade execution on SEFs and exchanges is in place without benefiting one execution platform over another. Temporary registration for existing trade execution platforms should be fashioned into final rules in order to avoid disrupting market activity and provide a framework for compliance with the new rules. The failure of the Commissions to provide interim or temporary relief for existing trading systems or platforms may alter the swaps markets and unfairly induce market participants to trade outside the U.S. or on already registered and operating exchanges.

The 15 Second Rule

There does not appear to be any authority for the CFTC's proposed requirement that, for "Required Transactions," SEFs must require that traders with the ability to execute against a customer's order or execute two customers against each other be subject to a 15 second timing delay between the entry of those two orders (15 Second Rule). One adverse impact of the proposed 15 Second Rule is that the dealer will not know until the expiration of 15 seconds whether it will have completed both sides of the trade or whether another market participant will have taken one side. Therefore, at the time of receiving the customer order, the dealer has no way of knowing whether it will ultimately serve as its customer's principal counterparty or merely as its executing agent. The result will be greater uncertainly for the dealer in the use of its capital and, possibly, the reduction of dealer activities leading, in turn, to diminished liquidity in and competitiveness of U.S. markets with costly implications for buy-side customers and end users.

While this delay is intended by the CFTC to ensure sufficient pretrade transparency, under the CEA, transparency must be balanced against the liquidity needs of the market. Once a trade is completed when there is agreement between the parties on price and terms, any delay exposing the parties to that trade to further market risk will have to be reflected in the pricing of the transaction, to the detriment of all market participants.

Ensuring That Block Trade Thresholds Are Appropriately Established

The most important aspect to ensuring that appropriate block sizes are set, is for the Commission to integrate the new reporting requirements first, and than establish block trade thresholds based on the comprehensive and reliable market data produced from these reporting requirements. From the perspective of intermediaries who broker transactions of significant size between financial institutions, it is critical that the block trade threshold levels and the reporting regimes related to those transactions are established in a manner that does not impede liquidity formation. A failure to effectively implement block trading thresholds will frustrate companies' ability to hedge commercial risk. Participants rely on swaps to appropriately plan for the future, and any significant changes to market structure might ultimately inhibit economic growth and competitiveness.

Establishing the appropriate block trade thresholds is of particular concern for expectant SEFs because the CFTC's proposal regarding permitted modes of execution restricts the use of voice-based systems solely for block trades. While WMBAA believes that this approach is contrary to the SEF definition (as discussed above), which permits trade execution through any means of interstate commerce, this approach, if combined with block trade thresholds that are too high for the particular instrument, would have a negative impact on liquidity formation.

With respect to block trade thresholds, the liquidity of a market for a particular financial product or instrument depends on several factors, including the parameters of the particular instrument, including tenor and duration, the number of market participants and facilitators of liquidity, the degree of standardization of instrument terms and the volume of trading activity. Compared to commoditized, exchange-traded products and the more standardized OTC instruments, many swaps markets feature a broader array of less-commoditized products and larger-sized orders that are traded by fewer counterparties, almost all of which are institutional and not retail. Trading in these markets is characterized by variable or noncontinuous liquidity. Such liquidity can be episodic, with liquidity peaks and troughs that can be seasonal (*e.g.,* certain energy products) or more volatile and tied to external market and economic conditions (*e.g.,* many credit, energy, and interest rate products).

As a result of the episodic nature of liquidity in certain swaps markets combined with the presence of fewer participants, I and my fellow WMBAA members believe that the CFTC and SEC need to carefully structure a clearing, trade execution and reporting regime for block trades that is not a "one size fits all" approach, but rather takes into account the unique challenges of fostering liquidity in the broad range of swaps markets. Such a regime would provide an approach that permits the execution of transactions of significant size in a manner that retains incentives for market participants to provide liquidity and capital without creating opportunities for front-running and market distortion.

To that end, we support the creation of a Swaps Standards Advisory Committee (Advisory Committee) for each Commission, comprised of recognized industry experts and representatives of registered SDRs and SEFs to make recommendations to the Commissions for appropriate block trade thresholds for swaps. The Advisory Committee would (1) provide the Commissions with meaningful statistics and metrics from a broad range of contract markets, SDRs and SEFs to be considered in any ongoing rulemakings in this area and (2) work with the Commissions to establish and maintain written policies and procedures for calculating and publicizing block trade thresholds for all swaps reported to the registered SDR in accordance with the criteria and formula for determining block size specified by the Commissions.

The Advisory Committee would also undertake market studies and research at its expense as is necessary to establish such standards. This arrangement would permit SEFs, as the entities most closely related to block trade execution, to provide essential input into the Commissions' block trade determinations and work with registered SDRs to distribute the resulting threshold levels to SEFs. Further, the proposed regulatory structure would reduce the burden on SDRs, remove the possibility of miscommunication between SDRs and SEFs and ensure that SEFs do not rely upon dated or incorrect block trade thresholds in their trade execution activities. In fact, WMBAA members possess historical data for their segment of the OTC swap market which could be analyzed immediately, even before final rules are implemented, to determine appropriate introductory block trade thresholds, which could be revised after an interim period, as appropriate.

5. Wholesale Brokers, CROs, and the Responsible Oversight of SEFs

The WMBAA members look forward to performing our designated roles as SEFs under DFA. The wholesale brokerage industry is working hard and collaboratively with the two Commissions to inform and comment on proposed rules to implement DFA. The WMBAA has submitted several comment letters[7] and expects to provide further written comments to the CFTC and SEC. The WMBAA has also hosted the first conference, SEFCON 1,[8] dedicated specifically to SEFs, and is currently making arrangements for a second SEFCON later this year. Further, the WMBAA has conducted numerous meetings with Commissioners and staffs. We and the wholesale brokerage industry are determined to play a constructive role in helping the SEC and the CFTC to get the new regulations under Title VII of DFA right.

It is clear, however, that the implementation of Dodd-Frank will create a host of new obligations for both SEFs and regulatory agencies. These include requirements that are typical for exchanges and self-regulatory organizations, such as requirements to (1) establish, investigate, and enforce rules; and (2) monitor trading and obtain information necessary to prevent manipulation.

Many likely SEFs are not currently regulated as exchanges, but rather as futures commission merchants (FCMs), broker-dealers or, where applicable, as alternative trading systems (ATS). As a result, these entities have familiarity with the rules of one or more self-regulatory organizations, such as FINRA or the NFA, which together with the Commission and the CFTC, will perform many of the regulatory functions assigned by the Dodd-Frank Act to SEFs.

In order to facilitate the development and success of SEFs, the WMBAA proposes the establishment of a CRO that will facilitate all SEFs compliance with the core

[7] *See,* Comment Letter from WMBAA (November 19, 2010) (11/19/10 WMBAA Letter); Comment Letter from WMBAA (November 30, 2010) (11/30/2010 WMBAA Letter); 1/18/11 WMBAA Letter; Comment Letter from WMBAA (February 7, 2011) (2/7/11 WMBAA Letter); and Comment Letter from WMBAA (June 3, 2011) (6/3/11 WMBAA Letter).

[8] SEFCON 1 was held in Washington, DC, on October 4, 2010. The keynote address was given by CFTC Commissioner Gary Gensler.

principles. Membership in the CRO would be voluntary and open to any entity intending to register as SEF, though member SEFs would be contractually bound to abide by the rules. Further, as a voluntary organization, the CRO would not necessarily need legislative or rulemaking authority to proceed. The creation of a CRO would also prevent market participants from selectively choosing which SEF to use based upon the leniency of its rules regime. The WMBAA believes that an industry-wide standards body would best ensure the integrity of the swaps market and protect market participants from abusive trading practices. Moreover, by acting as an intermediary for compliance by its members, the CRO would simplify the CFTC's and SEC's oversight responsibilities for SEFs.

Conclusion

Dodd-Frank seeks to reengineer the U.S. swaps market on three key pillars: record keeping and reporting; central counterparty clearing; and the mandatory intermediation of clearable trades through registered intermediaries such as SEFs. Wholesale brokers are today's central marketplaces in the global swaps markets and, as such, can be the prototype of SEFs.

Liquidity in today's swaps markets is fundamentally different than liquidity in futures and equities markets and naturally determines the optimal mode of market transparency and trade execution. Wholesale brokers are experts in fostering liquidity in noncommoditized instruments by utilizing methodologies for price dissemination and trade execution that feature a hybrid blend of knowledgeable qualified voice brokers and sophisticated electronic technology. Wholesale brokers' varied execution methodologies are specifically tailored to the unique liquidity characteristics of particular swaps markets.

It is critical that regulators gain a thorough understanding of the many modes of swaps trade execution currently deployed by wholesale brokers and accommodate those methods and practices in their SEF rulemaking. Too many of the SEC's and CFTC's Title VII proposals are based off of rules governing the equities and futures markets and are ill-suited for the fundamentally different liquidity characteristics of today's swaps markets.

We appreciate the Commissions' recognition of the deliberation and thought necessary to get these rules right, and are generally supportive of the phase-in approach being pursued. Rushing the rulemaking process and getting things wrong will negatively impact market liquidity in the U.S. swaps markets, disturbing businesses' ability to hedge commercial risk, to appropriately plan for the future and, ultimately, stifle economic growth and job creation. Taking adequate time to get the Title VII regulations right will expedite the implementation of the worthy goals of Dodd-Frank: central counterparty clearing and effective trade execution by regulated intermediaries in order to provide end users with more competitive pricing, increased transparency and deeper trading liquidity for their risk management needs.

With Congress' help, and the input and support of the swaps industry, regulators can continue their dedicated efforts at well-crafted rulemaking. If we are successful, our U.S. financial system, including the U.S. swaps markets, can once again be the well ordered marketplace where the world comes to trade.

Thank you for your consideration. I look forward to answering any questions that you may have.

PREPARED STATEMENT OF CHRIS BURY

COHEAD OF RATES SALES AND TRADING, JEFFERIES & COMPANY, INC.

JUNE 29, 2011

Good morning. My name is Chris Bury and I am the Cohead of Rates Sales and Trading for Jefferies & Company, Inc. Chairman Reed and Ranking Member Crapo, thank you for inviting me to testify this morning regarding the emergence of swap execution facilities or, as they have come to be known, SEFs.

Jefferies is a full-service global securities and investment-banking firm that, for almost 50 years, has been serving issuers and investors. We provide investment banking, and research sales-and-trading services and products to a diverse range of corporate clients, Government entities, institutional investors and high net worth individuals. The last few years have been a pivotal time for Jefferies as we gained market share and built significant momentum by capitalizing on strategic opportunities to expand and diversify on multiple levels and across all business lines. Over the last 5 years, our firm's annual revenue, equity market capitalization and global headcount have increased significantly, with now almost $3 billion in annualized net revenue, over $4 billion in equity market value, and soon-to-be 3,600 employees.

It bears noting that during that same period—that is, during the financial crisis—at no time did Jefferies seek or receive taxpayer assistance. As a publicly traded company on the New York Stock Exchange, our capital comes solely from the markets, and Jefferies' ability to persevere and emerge from the financial crisis positioned for growth and diversification can best be attributed to the firm's focus on a strong capital position, ample liquidity, and sound risk management.

There are a few key points that Jefferies would like to convey to the Subcommittee:

- *First,* we are ready to go. From our perspective, the architecture, infrastructure and technology necessary to bring the over-the-counter derivatives markets into an era of transparency, dispersed counterparty risk and open access are in place. Just as we are a leading provider of liquidity and execution in stock and bonds, we believe we can become a leading provider to buyers and sellers of derivatives. The market awaits the adoption of final rules—it is a fallacy to suggest that rules should be delayed to allow more time for this market structure to develop.
- *Second,* we believe that those sections of Title VII of Dodd-Frank pertaining to SEF trading of derivatives are necessary to remedy the artificial barriers to entry in the OTC derivatives market. It is with the intention of enhancing market participation and fostering competition that we support prompt implementation of these requirements.
- *Third,* implementation timelines should be the top priority at this juncture. The proposed rules are generally clear and understandable. The market needs the certainty of when the rules will become applicable far more than it needs any more suggestions about how bilateral agreements offer an alternative to central clearing.
- *Fourth,* it is vitally important to guard against the development of market structures that enable opaque bilateral contract relationships to continue to exist. Current standardized-execution-agreement proposals for centrally cleared swaps do nothing but preserve the closed and anticompetitive elements of these markets as they existed prior to the financial crisis.
- *Fifth,* the adoption of the rules and a clear timeline for implementation of Title VII will bring to the markets the same clear benefits gained from similar developments in equities and futures markets: increased access, expanded competition, improved price transparency, and decentralized risk. SEF trading will lead to lower transaction costs, greater liquidity, strengthened market structures and reduced implicit risks to market participants and the American taxpayer.

For years, firms such as Jefferies were effectively locked out of being a dealer in the OTC markets by virtue of a series of artificial barriers and requirements that perpetuated a closed system. Market participants were reliant upon bilateral contract arrangements with a self-selected group of large interconnected banks, dealers and insurers. The weaknesses and lack of true competition of that closed system exacerbated the credit crisis of 2008 to the great expense of our economy. We support the implementation of SEF trading as quickly and responsibly as possible. We believe that these provisions will increase transparency, reduce systemic risk, increase competition, and broaden access to centralized clearing within the derivatives market place.

From our perspective, the development of the SEF market and access to SEFs are fairly straightforward. In addition, the rules as jointly proposed by the Commodity Futures Trading Commission and Securities and Exchange Commission with regard to mandatory exchange or SEF trading are clear.

Jefferies' main concern, therefore, is not centered around a lack of understanding of the rules, nor around the notion that the rules are being implemented before the SEF market has developed. Quite to the contrary: Jefferies is concerned that a rule delay is one of the biggest risks facing this emerging SEF marketplace today. We believe the market will successfully transition to SEF trading once a timeline is established in terms of what types of swaps will be required to transact on a SEF.

Another risk to the development of the cleared derivatives market is the potential for the handful of too-big-to-fail banks that were bailed out by taxpayers to undermine and delay implementation of derivatives reform. We believe that recent suggestions from those banks regarding alternative documentation and workflow issues are nothing more than an effort to stifle competition and maintain the *status quo.*

We believe that the concern over these workflow issues and "what-if" scenarios will rapidly fade once the scale and scope of the technological investment in SEFs and a centrally cleared derivatives marketplace is better understood. Significant technological, financial and intellectual resources have been committed by a wide variety of market participants to get SEFs up and running as quickly as possible. Those investments have paid off, as the *Financial Times* noted last month in its special report on derivatives: "[T]he main participants, banks, interdealer brokers and 'big end users' are ready to go when it comes to electronic trading and clearing." (*Financial Times* Special Report, May 31, 2011, as quoted in SDMA Letter to CFTC and SEC dated June 1, 2011.)

The article went on to note that SEF-compliant trades between swap dealers and major swap participants have been reported on Javelin, TradeWeb, MarketAxess, and Bloomberg in both interest rate swap and credit default swap products.

Our industry is, indeed, approaching full readiness for standardized OTC derivatives contracts to begin trading on SEFs. If the proposed rules are implemented by the end of 2011, Jefferies would anticipate that trading volumes will begin increasing by the fourth quarter of this year and then increase significantly into 2012 as we approach final implementation of mandatory SEF trading of standardized derivatives. A firm timeline for mandatory SEF trading of the most standardized swaps will be instrumental for the market to achieve its full potential.

More importantly, delaying the implementation process will provide opportunities for entrenched interests to promote agreements that will degrade and deter free market forces from operating in the derivatives arena. The recently released Futures Industry Association (FIA) Cleared Swap Agreement is one such example. Although it is marketed as an industry-wide document developed by a variety of market participants, we are concerned that the published version, were it broadly adopted by market participants, would embed chokepoints into the system. Customer agreements that provide for either fallback provisions to bilateral relationships or workflows that require complicated credit limit checking arrangements, as the current FIA offering proposes, will not foster a fully transparent, open, and competitive market. Congress and the regulators should encourage market participants to adopt agreements and market frameworks that provide for immediate certainty of clearing in order to advance the open access provisions and central clearing mandate of Dodd-Frank.

Conclusion

Jefferies believes that implementation of Title VII reforms will unleash free market forces held in check by entrenched business models, and we are ready and eager to compete in the derivative marketplace. Thank you for inviting me to testify today, and I look forward to any questions the Subcommittee may have.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM KEVIN MCPARTLAND

Q.1. The reporting requirements that the CFTC/SEC has proposed for all SEFs transactions will require virtual real-time reporting of key transaction data. Won't liquidity providers (*i.e.,* dealers) increase their bid/ask spreads to reflect the increased risks associated with communicating key data to the marketplace (since dealers will not be able to hedge these positions before they are front-run)? In order to justify this risk, won't liquidity providers necessarily pass these increased costs to end users? In your view, does moving to SEFs justify these increased costs and reduced liquidity?

A.1. In the most liquid products reporting requirements will be of little long term consequence. To those in the market already, pricing data is in fact quite transparent and so additional dissemination will have little impact on spreads. For less liquid products however, it is very likely that a risk premium will now be embedded in the quoted price. However, even in today's market brokers often hedge new positions using other instruments such as futures and bonds to avoid being "picked off" by other market participants who are aware a trade just took place. This approach will become more prevalent in the new world.

It is important to note however that as the market becomes more electronic and more efficient, new liquidity providers will emerge to keep the prices between futures, bonds, and swaps very closely aligned. This will only make it easier to hedge a new swap position elsewhere with little market impact.

Q.2. The CFTC's proposed SEFs rules would require that market participants put out a minimum of five Requests for Quotes before they complete a transaction. Given that most of the OTC market currently trades in a nonstandardized form, wouldn't this requirement to garner five RFQs cause participants to share important information to the marketplace, which the market could use against that participant? In other words, wouldn't this requirement to trade with the RFQ model increase bid/ask spread for end users and potentially increase volatility?

A.2. It is first important to note that the majority of trading in interest rate swaps and credit default swaps occurs on standardized contracts. Vanilla U.S. Dollar interest rate swaps of standard durations (2 yr., 5 yr., 7 yr., 10 yr., 30 yr.) and index credit default swaps are in fact viewed as quite liquid by market participants. TABB Group's conversations with buy side traders, bulge bracket swaps dealers and midsized swaps dealers confirm this point.

That all said, these same market participants all believe that requiring an RFQ to be sent to five market participants would in fact widen spreads, decrease liquidity and drive trading to other products that did not have the same requirement. TABB Group believes that five is an arbitrary number and one that is not supported by historical precedent in this or any other financial market. Yet although we firmly believe a principles based approach to SEF regulation, one in which they are free to compete with each other based solely on their merits is best, in keeping with the goals of Dodd-Frank changing the RFQ requirement to read "more than one" would act as a reasonable compromise that would not impact the majority of RFQ trades done today.

Q.3. If the CFTC defines the size of a "block trade" too narrowly, then very few trades will be permitted off the SEFs. Given that most of the interest rate and credit default swaps trade in blocks too small to qualify as "blocks" under the new rules, wouldn't a phased-in approach be more appropriate than a cold-turkey move to the various SEFs rules? With regard to the CFTC's block rules, does the CFTC's one-size-fits-all approach make sense? Not all swaps have the same risk characteristics and lumping all interest rate swaps into one bucket for blocks (and similarly for CDS) does not seem consistent with market convention.

A.3. Setting the block trade size as a multiple of the current average trade size is unreasonable. The majority of swaps trades done today are in fact block trades. The average size of an interest rate swap is $129 million—but that is because much of the trading in this market is done by financial and commercial end users hedging real positions. That is in stark contrast to the highly electronic futures market where most market participants are looking for short term exposure to a particular reference entity. One can reasonably conclude that once the vanilla interest rate swap market is centrally cleared and traded electronically the average trade size could decrease by a factor of ten. That said, block sizes must be forward looking and take into account how these products are used and by whom.

Q.4. Do you envision that block trades will be treated differently by SEFs *versus* DCMs? If so, how and why?

A.4. Block trade rules are and should be focused on reporting and not on method of execution. As stated in our testimony, TABB Group strongly believes a principals based approach is best for the swap execution space allowing SEFs and DCMs alike to compete for liquidity based on trading mechanisms provided, price, technology and other competitive factors. That said, the time delay for reporting a block trade as well as the size of a block trade must be consistent regardless of where a trade is done. If one venue sets the block size lower than another we will quickly see liquidity move to the venue with the lower threshold. So ultimately, execution method should be left open to the venue but the block definition must be consistent systemwide.

Q.5. The margin calculation for SEFs (which requires a minimum 5-day liquidation period) *v.* DCMs (1-day liquidation period) has a significant impact on required margin. Why were these arbitrary liquidation periods established?

A.5. Market convention uses liquidation periods of between 1 and 10 days. 5-day liquidation is not uncommon. The liquidation period used to calculate margin is influenced by liquidity. The lower expected or perceived liquidity of an instrument, the wider the liquidation period (up to 10 days.) But since margin can be changed often, it is not critical to fixate on a particular look-back period as long as it is in the acceptable range. Furthermore, it makes sense that margin levels for newly clearable products would start out at a conservative point.

The longer the duration of a contract the greater the risk to the clearinghouse. As swaps tend to be of much longer duration (the 10-year interest rate swap is one of the most common) as compared to futures (often 3–6 months) the risk and hence the margin requirements are greater for swaps. TABB Group research has found that on the short end of the curve margin levels are in fact quite similar for swaps and futures. But as duration increases the gap widens considerably.

Q.6. We understand the CFTC is considering a different segregation regime for customer margin for SEFs *v.* DCMs. Why? What is the benefit?

A.6. Independent of the vernacular, there are two margin segregation schemes being contemplated. One is like the futures markets where customer funds are comingled in an omnibus account of the clearing member. The problem with this structure is that customers do not want to have exposure to one another for OTC derivative trades. The other segregation method is described as legally separated but operationally comingled. This format is intended to provide the margin benefits of the futures model without the exposure to defaulting parties.

In all cases, the benefit of pooling more margin funds is that it gives the clearinghouse the potential to offer margin offsets between more products, such futures and swaps (which are often used to hedge one another). In short, fund segregation regimes can determine the level of margin offsets (offered to spread products), and margin offsets are the primary key to lowering and ultimately minimizing the oncoming burdens of initial margin requirements for OTC derivatives.

Q.7. Why do the proposed SEF rules not allow for derivatives voice trading?

A.7. Yes, and they should. Swap transactions are often complex and very large. Following TABB Group conversations with real money buy side accounts, it became quite clear that the ability to speak with a broker is critical in the trading process for many. As a case in point, there is a reason why your average retail investor is still willing to pay $50 per trade to call in an order even though trading online is available for under $10 per trade. That said, we firmly believe that even for transactions discussed over the phone prompt entry into an execution platform for reporting purposes is critical to the ultimately transparency and success of the swaps market going forward.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM NEAL B. BRADY

Q.1. A number of participants have expressed concern about a potential lag between execution and clearing that could leave counterparties exposed to a trade that will be eventually unwound. Mr. Brady, in your testimony, you state that this concern "is exaggerated." Would you go into more detail on your views regarding swap trades that fail to clear or so-called clearing "fails"?

A.1. Eris Exchange believes that concern about "fails" on SEFs is exaggerated and addressable by applying a futures industry solution that has been in place for a long time; namely, pretrade credit checks and credit guarantees at the clearing firm level. By applying pretrade credit checks, the futures market model avoids the complexity of resolving post-trade operational issues that could result in a "fail." In addition, by applying pretrade credit checks, the futures market model "prequalifies" individual participants to trade with each other as long as each participant is guaranteed by a registered clearing firm. This market model vastly simplifies documentation requirements for end users, eliminates the need for end users to enter into complex trilateral agreements, greatly expands access, and allows end users to transact cleared swaps while preserving anonymity.

Under the futures market model, and, specifically, at Eris Exchange, clearing firms manage and administer pretrade credit checks themselves, and therefore there is no risk of trade rejection at the Clearinghouse due to insufficient credit or any other post-trade operational issue. The acceptance of a trade by the Clearinghouse occurs in milliseconds. Importantly, in the futures market model, executing brokers are also guaranteed by their primary clearing firm. Thus, at every point in the execution chain, a clearing member stands behind every futures contract trade.

If SEFs were to conform more closely to the futures industry model, this would alleviate the need for end users on SEFs to enter into complicated trilateral documentation negotiations and would also address another significant concern raised by major buy side participants—end users' desire not to reveal their identity—to remain anonymous—during the execution process.

In the futures exchange model and at Eris Exchange, each participant enters into a single agreement totaling two pages with a clearing firm, one time, and then the participant is eligible to trade, anonymously, with any other participant backed by any other registered clearing firm.

In sum, the futures model: (1) does not subject end users to "trade uncertainty" and the potential for "fails"; (2) greatly streamlines the documentation process; (3) opens up access to a much wider and diversified range of market participants; and (4) preserves anonymity during the trade process, therefore ensuring the most competitive and cost effective execution for end users.

The CFTC has recently proposed rules in response to the "fails" and documentation debate that applies the futures exchange model to the execution of swaps. *See,* 76 FR 45724 (Clearing Member Risk Management) and 76 FR 45730 (Customer Clearing Documentation and Timing of Acceptance for Clearing). The proposed rulemaking on clearing member risk management would, among other things, require swap dealers, major swap participants, and futures commission merchants that are clearing members to use automated means to screen orders for compliance with the risk-based limits. The proposed rulemaking on customer clearing documentation and timing of acceptance for clearing would, among other things permit derivatives clearing organizations (DCOs) to screen trades against applicable product and credit criteria before accepting or rejecting them "as quickly as would be technologically practicable if fully automated systems were used." Eris Exchange is supportive of these proposed rules for the reasons set forth above, as well as in the Exchange's testimony.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM NEAL B. BRADY

Q.1. The reporting requirements that the CFTC/SEC has proposed for all SEFs transactions will require virtual real-time reporting of key transaction data. Won't liquidity providers (*i.e.,* dealers) increase their bid/ask spreads to reflect the increased risks associated with communicating key data to the marketplace (since dealers will not be able to hedge these positions before they are front-run)? In order to justify this risk, won't liquidity providers necessarily pass these increased costs to end users? In your view, does moving to SEFs justify these increased costs and reduced liquidity?

A.1. Eris Exchange strongly disagrees with the assumption embedded in the question above—that price transparency and real-time reporting leads to increased costs for end users. To the contrary, price transparency decreases end users' execution costs.

As has been empirically shown in cash Treasury markets, Treasury futures markets, Eurodollar futures markets, and a host of other asset classes that have evolved to screen-based trading, real-time reporting leads to narrower bid/ask spreads, greater price transparency, and therefore decreased costs for end users. Real-time reporting also leads to deeper liquidity from a more diversified pool of liquidity providers, and therefore spreads trading inventory across a broader range of counterparties, which decreases systemic risk. Furthermore, real-time price reporting substantially decreases systemic risk by providing clearinghouses, regulators, clearing firms and end user participants with the trade information necessary to monitor and manage intraday risk.

As for the concern about "front running" of liquidity provider hedges, this is best addressed by an appropriate and flexible block trading requirement. The futures market is a great example of how bilateral block trades and a transparent Central Limit Order Book (CLOB) can exist and thrive operating side-by-side. In the futures markets, all trades below the block threshold are transacted centrally, and prices are reported instantaneously. Above the block trade threshold, where end user trades are large enough that liquidity providers have a legitimate concern about being "front run" on their hedges, market participants are allowed to transact bilaterally, and report these trades within an exchange-defined time limit. This framework has worked extremely well in the futures markets for many decades and has led to much tighter, rather than wider, bid-ask spreads. In other words, the efficiencies in the transparent, yet flexible, futures industry marketplace have allowed liquidity providers to pass on lower execution costs to end user clients.

While certain flexibilities for block trades are appropriate, such rules must be balanced with the harm that can result from too many block trades. Specifically, an excessive number of block trades in a given market can impact the quality of the markets offered in the CLOB. In a market that has excessive block trading, liquidity providers active in the CLOB are forced to make markets without access to critical price information. In addition, many of the trades that come into the CLOB are simply hedging activity resulting from block trades that have occurred outside the centralized market. In this market scenario, liquidity providers in the CLOB are forced to widen their bid/ask, which in turn results in more block trades.

Given the potential for harm to the CLOB of excessive block trading, it is important to set block trade thresholds high enough so that the only block trades permitted are those that would have otherwise materially impacted the market. The CFTC's proposed rule for futures block trades on designated contract markets (DCMs) provides guidance on how block size should be determined, including that the acceptable "minimum block trade size should be a number larger than the size at which a single buy or sell order is customarily able to be filled in its entirety in that product's centralized market without incurring a substantial price concession." *See,* 75 FR 80572, 80630 (Acceptable practices for block size determination).

Q.2. The CFTC's proposed SEFs rules would require that market participants put out a minimum of five Requests for Quotes before they complete a transaction. Given that most of the OTC market currently trades in a nonstandardized form, wouldn't this requirement to garner five RFQs cause participants to share important information to the marketplace, which the market could use against that participant? In other words, wouldn't this requirement to trade with the RFQ model increase bid/ask spread for end users and potentially increase volatility?

A.2. When discussing the issue of appropriate market protocols, it is important to distinguish between standardized (liquid) products and nonstandardized (illiquid) products. Eris Exchange is live and operational today in a very liquid and standardized market for vanilla interest rate swaps derivatives.

For highly liquid and standardized markets like markets in "plain vanilla" interest rate products, which is estimated to account for more than 50 percent of OTC turnover, swaps or futures equivalents can be readily traded with a "5 RFQ" protocol, as well as a CLOB. Specifically, at Eris Exchange, which has applied to become a DCM, trades in the Eris interest rate swap futures contract can only be done via either the CLOB or an RFQ that initiates an all-to-all central limit order book. While some may view this DCM requirement for transparency as a deterrent for liquidity providers to publish tight bid-ask, the empirical evidence points to the contrary: transparency, open access, and protocols that create a level playing field for competition have historically resulted in lower costs for end users. For DCOs, transparency also means there will be ample data available that is necessary for valuing and settling contracts, which ultimately allows for lower margin and better management in default situations. And, finally, for regulators, transparency means better monitoring of the marketplace.

While a CLOB represents the most developed trading platform, Eris Exchange believes that in this time of transition, "principles-based" regulation—meaning the Commission provides concepts for compliance with the Act—will permit SEFs with the flexibility to comply with the Act.

As for nonstandardized products, there is still question as to whether or not such products will be subject to the clearing mandate.

Q.3. If the CFTC defines the size of a "block trade" too narrowly, then very few trades will be permitted off the SEFs. Given that most of the interest rate and credit default swaps trade in blocks too small to qualify as "blocks" under the new rules, wouldn't a phased-in approach be more appropriate than a cold-turkey move to the various SEFs rules? With regard to the CFTC's block rules, does the CFTC's one-size-fits-all approach make sense? Not all swaps have the same risk characteristics and lumping all interest rate swaps into one bucket for blocks (and similarly for CDS) does not seem consistent with market convention.

A.3. As was stated in the Exchange's testimony, Eris Exchange believes that (1) a one-size-fits-all approach to block trading rules does not make sense and (2) a principles-based approach works best. The principles-based approach to block trading limits has worked extremely well in the futures industry where DCMs determine their block trading rules.

The challenge the CFTC and the industry faces is that there will be multiple SEFs offering the execution of the same swap, so there should be consistency across SEFs. The CFTC addresses this challenge by including a proposed rule that requires Swap Data Repositories to set block trading sizes based on a prescribed formula. Instead of this prescriptive approach, the CFTC should consider having the SDRs use a principles-based approach to set block sizes, which will eliminate the need for a phased-in approach. The Commission can then periodically review the block trade thresholds and require SEFs to raise or lower these thresholds depending on how the market evolves.

As we also stated in our opening statement and in response to questions during the hearing, Eris Exchange believes that each asset class is unique and should have block limits that are tailored and appropriate for that particular asset class. Lumping interest rate swaps and CDS into a single bucket and treating these assets classes the same with regard to blocks is not consistent with market convention.

Q.4. Do you envision that block trades will be treated differently by SEFs *versus* DCMs? If so, how and why?

A.4. Eris Exchange believes that the Commission intentionally differentiated between the regulatory treatment of SEFs and DCMs. Specifically, SEFs and DCMs are held to very different standards of price transparency for swaps trades below the block trade threshold and therefore it makes sense to differentiate with respect to block trade thresholds and reporting requirements for swaps in these two very different types of markets.

Q.5. The margin calculation for SEFs (which requires a minimum 5-day liquidation period) *v.* DCMs (1-day liquidation period) has a significant impact on required margin. Why were these arbitrary liquidation periods established?

A.5. Eris Exchange does not believe that these proposed liquidation periods are arbitrary; rather, in proposing the rules related to minimum 5-day VaR for a SEF and 1-day VaR for a DCM, the CFTC clearly recognized the important distinction between executing trades on a DCM, as opposed to on a SEF. Specifically, DCMs are held to a higher standard of price transparency (*i.e.,* a CLOB) and therefore, should be allowed to receive margining treatment more akin to standardized futures markets than to SEF markets with more opaque execution methods. Given the execution standards for a DCM, the DCO can better ensure a liquidation time due to the active CLOB trading on a DCM. The DCM, anonymous CLOB model allows participants to trade in and out of products in a cost-effective and time-effective manner. The Exchange believes that the transparency of a CLOB-driven DCM swaps market is a very valuable addition to the post Dodd-Frank marketplace and a clear example of some of the benefits that will be delivered to end user clients as a result of the regulatory reform.

Q.6. We understand the CFTC is considering a different segregation regime for customer margin for SEFs *v.* DCMs. Why? What is the benefit?

A.6. As a futures market, Eris Exchange contracts will be placed in the traditional futures account, the 4d account. It is worth noting that the CFTC has proposed using different segregation regimes for swaps regardless of whether the transaction is executed on a SEF or DCM. Therefore, if a DCM offers the trading of futures and swaps, it is possible that a given client's futures contracts will be in one account for futures (*i.e.,* Futures or Baseline Model) and a different account for swaps (*e.g.,* Complete Legal Segregation Model).

In general, Eris Exchange operates under a futures margining framework and believes that this framework has worked extremely well for the futures industry.

Q.7. Why do the proposed SEF rules not allow for derivatives voice trading?

A.7. The proposed SEF rules do provide a role for voice trading; however, the proposed rules balance this role with the transparency requirements of the Dodd-Frank Act. As discussed in the CFTC's proposal:

> While not acceptable as the sole method of execution of swaps required to be traded on a SEF or DCM, the Commission believes voice would be appropriate for a market participant to communicate a message to an employee of the SEF, whether requests for quotes, indications of interest, or firm quotes. For instance, voice-based communications in the proposed SEF context may occur in certain circumstances, such as when an agent: (1) assists in executing a trade for a client, immediately entering the terms of the trade into the SEF's electronic system; or (2) enters a bid, offer or request for quote immediately into a SEF's electronic multiple-to-multiple trading system or platform. [76 FR 1214, 1221]

It is also important to note that voice trading is permitted with regard to block trades or other "permitted Transactions" as defined in the CFTC's SEF proposed rule. *Id.* at 1241.

As an electronic futures exchange, Eris Exchange does not permit voice trading to execute standard/nonblock trades. However, the Exchange does have rules related to block trades, which can be voice brokered.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY THE INVESTMENT COMPANY INSTITUTE

Statement for the Record of the Investment Company Institute

Hearing on "Emergence of Swap Execution Facilities: A Progress Report"

Subcommittee on Securities, Insurance and Investment

Committee on Banking, Housing and Urban Affairs

U.S. Senate

June 29, 2011

The Investment Company Institute very much appreciates the opportunity to submit testimony to this Subcommittee and offer our perspectives on certain aspects of the development of swap execution facilities ("SEFs"). ICI is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts (collectively, "funds").[1] Members of ICI manage total assets of $13.41 trillion and serve over 90 million shareholders.

The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") will dramatically change the derivatives markets, establishing a regulatory framework for the swaps markets and their participants.[2] Funds are participants in these markets, using swaps and other derivatives in a variety of ways to manage their portfolios.[3] Accordingly, ICI and its members have encouraged reform efforts in these markets,[4] including by urging the Commodity Futures Trading

---

[1] Throughout this testimony, references to "funds" and the "fund industry" refer only to those funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940.

[2] Throughout this testimony, we will use the term "swaps" to refer to both swaps and security-based swaps.

[3] For example, funds use derivatives to hedge positions; equitize cash that a fund cannot immediately invest in direct equity holdings; manage the fund's cash positions more generally; adjust the duration of the fund's portfolio; or manage the fund's portfolio in accordance with the investment objectives stated in its prospectus.

[4] Testimony of Karrie McMillan, General Counsel, Investment Company Institute, before the Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, United States House of Representatives, on "Implementing Dodd-Frank: A Review of the CFTC's Rulemaking Process" (April 13, 2011) and Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of Representatives Committee on Financial Services on "Industry Perspectives on the Obama

Commission ("CFTC") and the Securities and Exchange Commission ("SEC"; together, "Commissions") to promulgate regulations in a manner that provides the protections sought by the Dodd-Frank Act while minimizing disruptions to the markets, market participants, and customers. [5]

Pursuant to Title VII of the Dodd-Frank Act, swaps subject to the new mandatory execution requirement will be permitted to be traded on SEFs as well as on designated contract markets ("DCMs"). As execution facilities, SEFs will be one of the avenues through which funds determine whether and how to interact in the swaps market. The appropriate regulation of SEFs and their role in the new regulatory structure will be critical to ensuring transparency, price efficiency, liquidity and stability in the swaps markets.

Investor Representation on SEFs

As participants in the swap markets, funds have a strong interest in ensuring that these markets are highly competitive, transparent, and efficient, and operate in a manner that treats all market participants fairly. To that end, SEFs should include investor representatives on their boards of directors. Requiring investor representation in the governance structure of a SEF minimizes conflicts of interest by better balancing the advancement of commercial interests with the fulfillment of self-regulatory responsibilities. Conflicts of interest that may exist include: limiting SEF membership to minimize risk exposure and preserve the swap entity's profits; limiting the scope of products eligible for clearing, particularly if there is a strong incentive to keep a product traded in the OTC market; and maintaining lower risk management controls to reduce the amount of collateral and liquidity that the SEF's members are required to post. A regulatory structure that aids in controlling these conflicts of interest should help prevent a SEF from putting its interests and those of its members[6] ahead of its regulatory responsibilities by failing to take necessary action or appropriately manage risk exposure. It also should, in turn, reduce systemic risk in the swap markets. In addition, investor representation would level the playing field for SEFs by creating a governance structure wherein SEFs operate under similar restraints on the influence of owner and member self-interests, which would benefit new SEFs in the market.

Administration's Financial Regulatory Reform Proposals" (July 17, 2009), available at http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny.

[5] The Dodd-Frank Act was enacted to reduce risk, increase transparency, and promote market integrity within the financial system.

[6] For purposes of this letter, "members" refers to members, participants, and enumerated entities as used by the Commissions in their proposals.

In addition to board representation, we strongly support investor representation on board advisory committees, including swap review committees.[7] These committees are designed to facilitate meaningful discussion on important issues before the board. Such advisory committee representation, however, should not be a substitute for investor representation on the board itself. This is particularly true in the developing swap markets where, at this time, investors have access to only a handful of venues for clearing and trading.

Preserve Flexibility of Trading on SEFs

The SEF provisions in the Dodd-Frank Act are designed to encourage swap trading on SEFs by providing a flexible execution framework. To achieve this goal, implementing regulations must strike an important balance between transparency on the one hand and the necessary flexibility to encourage use of the SEFs on the other. We are concerned, however, that the trading restrictions in the SEC's and CFTC's SEF-related proposals would hamper the migration of swaps to the cleared and SEF-executed market by enhancing transparency at the expense of liquidity and efficient pricing.[8] In particular, ICI is concerned about the CFTC's prescriptive requirements regarding the request for quote ("RFQ") process and the SEC's requirement to interact with bids and offers resting on the SEF.

The RFQ Process

ICI supports the Commissions' proposed use of RFQ systems for the execution of swaps but questions the CFTC proposal to require that a RFQ be sent to five or more dealers. If a fund is required to go to five swap dealers prior to executing a swap transaction, it likely would suffer from information leakage and "signaling" regarding the potential transaction. Each of the five dealers would know that four others are also being approached about the same deal. Such a situation could increase the potential for front running and make it likely that the price of the swap would move against the fund, resulting in the dealer paying a higher price for the second side of the transaction. In other words, market participants, including the five RFQ dealers, would adjust their trading activity based on information in the RFQ, thereby moving the market price. This higher price would be borne by funds and their shareholders in the form of a wider bid-ask spread.

[7] Both the New York Stock Exchange and the Nasdaq Stock Market, for example, have board advisory committees composed of institutional investors, *i.e.*, the NYSE Institutional Traders Advisory Committee and the Nasdaq Quality of Markets Committee.

[8] *See* CFTC Release, *Core Principles and Other Requirements for Swap Execution Facilities*, 76 FR 1214 (January 7, 2011), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-32358a.pdf and SEC Release No. 34-63825, *Registration and Regulation of Security-Based Swap Execution Facilities*, 76 FR 10948 (February 28, 2011), available at http://www.sec.gov/rules/proposed/2011/34-63825fr.pdf.

To eliminate concerns about information leakage or diminished liquidity, market participants should be provided with the flexibility to structure their RFQs on whatever basis they believe will serve their customers' interests, regardless of the number of providers they reach out to. Market participants should be permitted to enter swap transactions with the counterparties of their choosing. For example, given their legal and fiduciary duties, ICI believes that fund managers are well suited to determine the appropriate number of dealers in which to send a request. Moreover, there may be circumstances when trading swaps with low liquidity or volume in which five liquidity providers are not available; those available are not creditworthy; or those available do not satisfy various legal requirements. We therefore recommend that the CFTC consider the SEC's proposal, which would require that a SEF allow for market participants to disseminate an RFQ to one or more swap dealers.

Interacting with Bids and Offers

The SEC should eliminate the proposed requirement for market participants to interact with resting bids or offers. The SEC proposal would impose a price-time priority model on swaps executed on SEFs. Specifically, the SEC proposal would require that a SEF that allows participants to display firm quotes must be designated so that all trades, including those to be executed through the RFQ process, first interact with pre-existing resting bids and offers available at an equal or better price. This requirement to trade with better priced existing bids and offers raises several concerns, including nullifying the RFQ process and thereby hindering funds' execution strategies and objectives. Further, when considering the factors in addition to price that are a part of the calculation for the quality of swap execution, a higher priced bid or offer may not, in fact, be a better price for completion of the transaction. To the contrary, requiring a fund to break up its notional order to interact with a resting bid or offer could result in multiple trades instead of a single execution. This fragmentation of orders could result not only in higher transaction costs to funds and their shareholders but also additional reporting and margin costs for each transaction.

Consistency Between SEC and CFTC SEF Trading Restrictions

As discussed above, the SEC's and CFTC's proposed SEF trading restrictions vary significantly. A uniform approach to their respective rules is necessary to minimize operational difficulties for market participants, control for costs related to the new trading environment, and ensure that the final SEF rules accommodate flexible execution requirements that encourage trading on SEFs. For example, trading of all types of credit default swaps ("CDS") may occur on a fund's fixed-income desk. However, a CDS on a single security or narrow-based index would be subject to the SEC's SEF rules while a CDS on a broad-based index would be subject to the CFTC's SEF rules. Traders, operational and legal and compliance staff will be faced with the difficult task of ensuring application of the proper rule set, including compliance and risk policies and procedures, within the context of potentially rapidly trading swaps. In the absence of coordination between the CFTC and SEC on their SEF proposals, we therefore are concerned that the proposed SEF rules would be disruptive to the swaps markets and adversely affect execution quality.

Reporting of Swap Transaction Data and the Identification of Block Trades by SEFs

Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals that would require, upon execution, reporting of swap transaction data to a registered swap data repository ("SDR").[9] The SDR would make certain of the swap data publicly available in real time. Market transparency is a key element to ensuring the integrity and quality of these markets,[10] but ICI has several concerns with the proposals as they relate to block trades, and ultimately SEFs. To address these concerns, we have recommend that in each of their proposals the SEC and CFTC should (1) define a block trade by evaluating the market for a particular swap category to determine what might be an illiquid size and (2) ensure that SEFs can qualify as the reporting party in SEF-executed transactions. We also recommend that the Commissions harmonize and coordinate their proposals to the extent possible.

Block Trades and SEFs

Block trades enable funds, on behalf of their shareholders, to efficiently transact in large amounts off an exchange with minimal disruption to the swaps market. As with other swap transactions, block trades in swaps subject to clearing requirements under the new swaps regulatory framework will be required to be traded on DCMs or SEFs. This means that in addition to the regulatory and public reporting obligations in the SEC and CFTC proposals, block trades will be subject to the SEF trading restrictions discussed

[9] *See* CFTC Release, *Real-Time Reporting of Swap Transaction Data*, 75 FR 76139 (December 10, 2010), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-29994a.pdf and SEC Release No. 34-63346, *Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information*, 75 FR 75208 (December 2, 2010), available at http://www.sec.gov/rules/proposed/2010/34-63346fr.pdf.

[10] As part of its recommendations to the SEC and CFTC regarding the sequence for implementation of the new swaps regulatory framework, ICI has recommended that the Commissions begin by finalizing and implementing rules requiring reporting of swap transaction data to the regulators. Initially, reporting should be limited to non-public, regulatory reporting to gather data to inform regulations, for example, on block trading without significantly disrupting the swaps market and market participants' trading strategies by impacting liquidity. ICI believes that the information gathered through this process will assist the Commissions in better understanding the structure and operations of the swaps markets and adopting appropriately tailored and effective rules. Further, only after such analysis can the Commissions accurately determine the effect of public dissemination of certain of the swap transaction data. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated June 10, 2011 (commenting on phase-in schedule for requirements for Title VII of the Dodd-Frank Act), available at http://www.ici.org/pdf/25276.pdf.

above. For both of these purposes, it is critical that the Commissions identify the appropriate thresholds for block trades in the swaps markets to avoid significant disturbance to and negative implications for the swaps markets, participants and customers.

The CFTC has proposed to exempt block trades from the requirement to trade on a SEF. A SEF would still be required to process the block trade upon receipt of transaction data by the reporting party but the fund's trading strategy would not be dictated by the proposed SEF trading rules. The key to this exemption, however, is the threshold for block trades. If the CFTC adopts thresholds that do not recognize the liquidity of the various swaps markets, trades that otherwise should be block trades will still be required to trade on a SEF with all of the concerns discussed below.

After a block trade has been executed, one or more of the counterparties will seek to reduce risk by hedging its exposure, usually by transacting on an exchange. Knowledge of a block trade therefore signals to other market participants that there is the potential for subsequent trading activity.[11] This signaling can negatively affect the market and fund shareholders by significantly skewing pricing if the market does not have sufficient time to digest the block order. In addition, opportunistic market participants may piece together information about a fund's holdings or trading strategy, leading to front running of a fund's trades, which also adversely impacts the price of the swap and the underlying asset to the detriment of fund shareholders.

Flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity. The ideal way to identify the appropriate thresholds for block trades in the swaps market is to account for the liquidity in each unique category of swaps.[12] The risks, trading and liquidity associated with a particular swap differ for each individual swap category within an asset class based on type, term and underlying security.[13] The SEC and CFTC should reflect these granular but significant differences by creating narrow buckets to which the threshold formulas would apply.[14]

---

[11] In post-transaction analysis of block trades, our members report being able to see that the market tracked their movements.

[12] Under the proposed CFTC thresholds, many transactions that should be treated as block trades would not qualify as such. The SEC proposal does not include thresholds. Instead, the SEC seeks comment on the general criteria that should be used by SDRs to determine whether a transaction is a block trade.

[13] The SEC proposal states that it would be inappropriate to establish different thresholds for similar instruments with different maturities. We strongly disagree because of the unique characteristics associated with each swap.

[14] The CFTC has proposed a two-test model to determine the minimum block trade threshold, with the larger result from the test being the applicable threshold. The "distribution test" would provide that 5 percent of swaps in a category would be block trades, based on transaction sizes over the prior calendar year. The "multiple test" would provide that a block trade is one that is larger than the largest of five times the mean, median and mode of transactions in the category of swaps over the prior calendar year. We

These thresholds should be calculated regularly (*e.g.*, quarterly) to ensure that they are appropriately tracking liquidity in the swap categories.

In any event, however, the thresholds must be low enough to encourage the use of block trades. Setting the thresholds too high could result in fund managers breaking up large size trades to minimize the possibility of information leakage and front running, which could cause market disruption and additional costs to fund shareholders. Further, the Commissions should err on the side of caution by setting the thresholds low initially to collect data from SDRs to enable them to evaluate the thresholds and determine the appropriate delays for data dissemination.

Reporting Party

The SEC and CFTC proposals take different approaches to identify the proposed reporting party for a swap transaction. Under the CFTC proposal, the reporting requirement would be satisfied if a swap is executed on a SEF. The SEC proposal establishes a hierarchy that identifies the reporting party to a swap transaction. Within this structure, the SEC proposal would permit a reporting party to enter into an agreement with a third party to report a swap transaction on behalf of the reporting party. In this way, a security-based SEF could transmit a transaction report for the swap to a registered SDR. ICI believes this extra step is unnecessary and burdensome. Absent an agreement by the parties to pursue an alternative reporting regime, a transaction executed on a SEF should be reported by that SEF.

Consistency between CFTC and SEC Reporting Requirements

As identified above, the SEC and CFTC proposals differ, sometimes substantially. The principles guiding the regulatory approaches and the underlying rules should be the same with respect to real-time reporting and SEFs. The approach to reporting should be uniform and consistent, reflecting the unique characteristics of the swaps market even though application of the final rules to the individual swaps within each Commissions' jurisdictions should ideally differ in recognition of the liquidity for those products. Duplicative requirements are burdensome and inconsistent requirements pose the potential for operational, legal and compliance problems.

At a minimum, we recommend that the agencies coordinate their proposals with respect to reporting parties, reporting time frames, data to be reported, the approach to establishing block trade thresholds, and the time frames and data requirements for reporting block trades. Such coordination would be in keeping with the Dodd-Frank Act mandates and would help to minimize excessive and unnecessary regulatory burdens caused by differing regulatory requirements.

---

recommend that the CFTC eliminate the "multiple test" from its proposal and, instead, implement a modified "distribution test" based on factors including, among others, product, liquidity and tenor.

Conclusion

We appreciate the opportunity to share our views with the Subcommittee, and we look forward to working with Congress and regulators as they seek to address these many important issues involved in implementing the SEF related-provisions of the Dodd-Frank Act.

PAPER SUBMITTED BY THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

ISDA. Safe, Efficient Markets

July 12, 2011

The Honorable Jack Reed
Chairman
Subcommittee on Securities, Insurance, and Investment
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Mike Crapo
Ranking Member
Subcommittee on Securities, Insurance, and Investment
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Reed and Ranking Member Crapo,

The International Swaps and Derivatives Association (ISDA) is pleased to submit the attached paper entitled Swap Execution Facilities: Can They Improve the Structure of OTC Derivatives Markets in connection with the June 29, 2011 Senate Banking Committee Hearings. We request the paper and this cover letter be included as part of the record of the hearing.

The paper describes the characteristics of the OTC derivatives marketplace and contrasts it with the markets for financial futures. OTC derivatives products trade much less frequently than the most liquid futures contracts but the average transaction size in OTC derivatives is much larger than that for futures contracts. This difference in market operation needs to be reflected in the rules governing swap execution facilities (SEFs).

The paper recommends that rules for SEFs be principle based rather than prescriptive. Indeed, SEFs should be permitted to be structured to provide maximum choice in trade execution to market participants. SEFs should enhance pre- and post-trade transparency but not at the cost of reducing liquidity as reductions in liquidity increase costs for end users.

SEF block trading exemptions and reporting delays should be reasonable, tailored and product specific. There is no reason why CFTC or SEC rules need to specify exact formulae for block trading exemptions rather than the principles that SEFs should employ in setting exemptions and delays. Block trading exemptions and reporting delays may always be tightened in the future if practice shows that tightening will not impede liquidity.

Rules should also not require products to be executed on SEFs unless the products are liquid and mature and "available to trade". This determination should be subject to liquidity, trading and standardization characteristics and should not be made by SEFs themselves but rather by the appropriate regulator after a public comment period.

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

ISDA.

Finally, the paper recommends that the CFTC and the SEC harmonize their SEF requirements both between each other as well as with foreign regulators.

ISDA is pleased to provide the paper and we welcome the opportunity to provide input on other matters relating to the OTC derivatives market.

Yours truly,

Conrad P. Voldstad

Robert G. Pickel

SWAP EXECUTION FACILITIES:

CAN THEY IMPROVE THE STRUCTURE OF OTC DERIVATIVES MARKETS?

March 2011

ISDA®
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

SWAP EXECUTION FACILITIES: CAN THEY IMPROVE THE STRUCTURE OF OTC DERIVATIVES MARKETS?

Executive Summary

This paper discusses important issues associated with mandating the use of swap execution facilities (SEFs) for executing certain OTC derivatives products. It asserts that such mandates should be structured in a way that preserves the OTC derivatives market's strengths while addressing its weaknesses, presents a set of desirable SEF characteristics to meet this objective and identifies relatively modest infrastructure and transparency benefits that SEFs might bring. The paper also analyzes the proposed rules of the CFTC and the SEC required by the Dodd-Frank Act (DFA) and makes recommendations to improve, in particular, the CFTC proposals in a manner consistent with a reasonable reading of DFA.

Structural changes to the OTC derivatives markets should be adopted flexibly to enable them to adjust and remain liquid. Changes should be carefully constructed to allow end users to retain (and possibly increase) their ability to effectively manage risk. To achieve these objectives, SEFs, at a minimum, should:

- Provide maximum choice in trade execution to market participants;
- Promote pre- and post-trade transparency while maintaining liquidity;
- Have reasonable, tailored and product specific block trade exemptions.

In addition,

- Rules should be flexible enough to allow business models to evolve over time;
- Products required to be traded in SEFs should be limited to liquid, mature products;
- Rules should not be simply imported from other, fundamentally different markets but should take into account the nature of the derivative products traded and the relative sophistication of the market participants.

To provide a useful context when examining the likely impact of SEFs on the trading of OTC derivatives, we start with an overview of the current market structure (Section I). Section II examines the market's strengths and weaknesses from the perspective of both users and regulators and presents several desirable characteristics of SEFs which should strengthen the market. The OTC derivatives market is compared with that of futures in Section III and

fundamental differences in their structures are highlighted. We then examine the CFTC and SEC proposed rules and critique provisions likely to have a negative impact on the market's flexibility and liquidity (Section IV). The last section contains recommendations for improving the proposed rules.

I. Current Market Structure for OTC Derivatives Products

Market Size and Trading Frequency

The OTC derivatives market has grown tremendously in terms of product range and size since its inception 30 years ago. The market now consists of five primary asset classes: interest rates, credit, commodities, equities and foreign exchange. However, other forms of derivatives, such as weather, longevity and catastrophe, are also used.

Most analysts use figures produced by the Bank for International Settlements (BIS) to describe the size of the market. As of June 30, 2010, the BIS estimated the market was $583 trillion in size as measured by the aggregate notional amounts of contracts outstanding. This estimate, however, is somewhat misleading. Many analysts exclude foreign exchange ($63 trillion) from the total as foreign exchange forwards pre-date other products by decades. The BIS estimate also splits in two swaps executed between dealers that are subsequently cleared by the London Clearing House (LCH). This essentially double counts these transactions. The LCH was clearing $229 trillion as of June 30, 2010 and so the total is overstated by $114.5 trillion. Another adjustment is to update the Credit Default Swaps (CDS) market totals for current data from the DTCC trade repository. If these adjustments are made, the marketplace is reduced to the following components:

A. Interest rate products:	$364 trillion
B. Credit products:	$27 trillion
C. Commodity contracts:	$3 trillion
D. Equity products	$7 trillion
Adjusted Total	$401 trillion

In all, interest rate products account for approximately 90% of the marketplace by notional. While notionals outstanding are very large[1], the number of transactions executed in any day is quite modest. For all interest rate products, some 5,500 trades are executed on an average day globally in over 20 currencies. CDS new trade volumes typically run approximately 7,000 per day. Only a small group of CDS reference names are traded more than 20 times a day. Over 4,000 names have traded with each name having multiples of 40 contracts each[2].

[1] The notional amount is the basis on which payments in a derivative contract are calculated. Actual net market value of future payments, using current market conditions, referred as the mark-to-market value is a better measure of the risk embedded in the contract and, almost always, a fraction of the notional. Aggregate mark-to-market value is about $25 trillion.

[2] Volumes fluctuate significantly over time. There were 21,690 new credit derivative trades (13,951 Single Name and 7,739 Index and Index Tranches) executed the week ending on March11, 2011. There was an increase of 19,438 trades in TriOptima's repository during the week ended on February 25, 2011. It is estimated that this increase represents approximately 80% of all trades in rate products completed, globally, in the period. Information on trading volumes for credit derivatives, rate derivatives, bonds and futures can

Bilateral Execution / Counterparty Credit Risk

Swaps are generally traded on a bilateral basis, i.e., between two counterparties. Most derivatives are executed between a bank dealer and its clients or between two dealers who seek to hedge risks they have taken or as a means of taking on new risk. In all, there are 14 very large global dealers but another 20 or so large banks are active in certain major markets. An exception to the bank dealer market is the commodity derivatives market where non-bank dealers are quite common. Dealers in the OTC derivatives markets act as principals, i.e., assume the market and credit risks associated with the trade until its maturity. In the futures markets, futures commission merchants (FCMs) act as agents for their clients.

OTC derivatives contracts are typically multi-year contracts and involve assumption of credit risk as market rates move. For example, if a counterparty receives fixed rates in a 5% environment for 10 years and the interest rate market moves to 3% in three years, the counterparty will be exposed to its client or bank to make good on the now off-market (in the money from the counterparty who receives the fixed rate payments point of view) derivative for the remaining life of the transaction. As can be seen, this credit relationship is, potentially, as long as the longest derivative contract between the two counterparties. To streamline and standardize documentation, master derivative agreements have been developed, governing a large percentage of all contracts. These agreements typically contain netting provisions, enabling counterparties to offset in the money trades (assets) against those out of the money (liabilities), thereby reducing exposure substantially. A majority of these master agreements also call for collateral to be exchanged between the parties to further reduce the netted exposure. These master agreements are negotiated with care to ensure each side is properly protected.

Clearinghouses

Certain derivatives contracts – plain vanilla interest rate contracts, many credit indices and nearly 200 CDS single name reference entities – are eligible to be cleared by clearinghouse members. In these transactions, the parties usually present a transaction to a clearinghouse for clearing approval. If the clearinghouse accepts the transaction, the bilateral contract is novated and the clearinghouse becomes the counterparty to each side of the transaction. The clearinghouse requires both initial margin and variation margin to protect itself.

Clearinghouses can bring significant benefits. The default of Lehman Brothers in 2008 provides an important example. At that time, the London Clearing House was able to liquidate over 60,000 trades representing over $8 trillion of notional value. Trades cleared by the two largest clearinghouses, the London Clearing House and the InterContinentalExchange ("ICE"),

be obtained from the DTCC (http://www.dtcc.com/products/derivserv/data_table_iv.php), TriOptima (http://www.trioptima.com/repository), FINRA (http://cxa.marketwatch.com/finra/BondCenter/Default.aspx) and the CME (http://www.cmegroup.com) respectively.

are almost entirely comprised of dealer to dealer trades.[3] Both of these have developed the means to clear transactions for clients of clearing members but little business has been executed to date.

Users of Derivatives Markets: Institutions

Who uses OTC derivative products? Virtually all non-dealer business is executed by large institutions - banks, investment managers, other financial firms, corporations hedging risk, and other similarly sophisticated market participants. While there are thousands of end users of OTC derivatives, perhaps 500 entities are active in global interest rates and a somewhat lower number of participants are active in credit products. Wider use of clearinghouses for over-the-counter derivative products has the potential to improve market resilience by lowering counterparty risk and increasing transparency.[4]

Pricing Derivative Products / Transparency

Nearly all users of OTC derivatives products have relationships with multiple dealers and two or more dealers are typically put into competition for each deal. Pricing is very competitive for standard transactions for creditworthy counterparties. This competition results in very narrow spreads for the most liquid products: plain vanilla interest rate swaps, many interest rate option products, credit indices and the most liquid single name CDS. Moreover, OTC derivative users are typically very sophisticated and experienced and are fully capable of executing less competitive transactions to their benefit. In fact, end users sometimes "choose not to broadcast their transaction details to multiple participants" in order to have access to efficient and cost effective hedging.[5] Recent surveys confirm that end users, by and large, are very satisfied with the service, including pricing, they get from dealers.[6]

Illustrative of these points is the blind test sponsored by ISDA in 2010[7]. In the test, three large investment managers asked groups of three dealers for firm pricing on five interest rate swaps denominated in USD or Euro. (Each investment manager had a unique set of swaps.) Interest rate swaps are quoted in basis points, i.e., hundredths of a percent. The average winning

[3] For a variety of reasons, a client transaction may be included in the "dealer to dealer" clearing metrics. Due to standard practices in the OTC derivative markets, clients may assign their role in a dealer-facing trade to another dealer while unwinding an open position, or may use a dealer to intermediate a trade when transacting with other dealers. In both instances, if a clearing solution is available, such client originated trades end up as dealer to dealer trades in clearing.

[4] *Central counterparties for over-the-counter derivatives*, S G Cecchetti, J Gyntelberg, M Hollanders, BIS Quarterly Review, September 2009, 45-58.

[5] See the Coalition for Derivatives Users letter to the CFTC dated Mach 8, 2011.

[6] ISDA End-User Survey: Interest Rate Swaps, October 2010.

[7] "Interest Rate Swap Liquidity Test" - a report sponsored by ISDA and conducted by Atrevida Partners in conjunction with market participants in November 2010.

quote for the 15 swaps was a mere one tenth of a basis point over the middle of the market at the time the quotes were sought.

In addition to obtaining competitive pricing on transactions, users of derivatives typically have screens from dealers, containing bid and offer indications for standard transactions. Vendors such as Bloomberg also provide composite pricing screens. A number of dealers currently have the means to permit electronic execution of transactions, primarily in interest rates swaps but also increasingly in other products. Inter-dealer brokers typically have live pricing screens, enabling dealers to execute electronically. There are also a few electronic platforms, such as Tradeweb, that are open to end users.[8]

Operational Infrastructure and Valuation

The operations underpinning OTC derivatives require a sophisticated set of systems and staff to cope with the deal flow. The industry has largely migrated to electronic confirmations of transactions, thereby reducing legal and documentation uncertainty that had persisted for the first two plus decades of the industry's life. Most large firms employ straight through processing, meaning once the trade is entered, everything else is done without human intervention.

Dealers and their clients need to value positions on a daily basis. Market prices, obtained from screens, are used as inputs to valuation models which calculate prices for existing positions. Theory behind the valuation models becomes generally accepted over time but changes do occur as has been witnessed in the interest rate swap market in just the last few years. Dealers need robust systems to price a large number of transactions for their books and records, risk management and daily reports for clients. Dealers also need significant analytical resources to ensure valuation techniques are adequate.

Summary

OTC derivatives are complex products, typically traded by professionals at large institutions, involving unlimited variations of terms, market risk and credit risk, that can be tailor-made to match the users' exact requirements, and requiring significant systems, analytical and legal support. In the next section, we will discuss how OTC derivatives are performing - what works, what goes wrong and, more importantly, what could go wrong.

---

[8] An electronic platform originally developed to facilitate bond trading. Tradeweb is owned by Thomson Reuters and 10 leading dealers.

II. Strengths and Weaknesses of the OTC Derivatives Market

Strengths

The OTC derivatives market has been remarkably successful in the 30 odd years of its existence. This success is directly related to: a) the flexibility of the product itself; b) the importance of the dealer-client relationship; c) market liquidity, d) legal certainty; e) credit risk management mechanisms the industry has developed; and f) the confidentiality of contracts.

Product Flexibility

The product is completely flexible. Products can be devised to manage exactly any specified risk - whether it be exposure to interest rates, inflation, commodities, weather, catastrophe, equities, credit, etc. The exposures do not have to be general. They can be as specific as the counterparties to transactions wish. Risks can be managed in scores of currencies with hundreds of swap and option products with virtually any start or maturity date.

Dealer-Client Relationship

The dealer-client relationship is central to the derivatives marketplace. Dealers take exposure to the risks that their clients want to hedge. Dealers also assume risk when clients put on new positions by taking take the opposite side in the trade. These risks include not only outright exposure to the principal product or market but also "basis" risk – mismatches of dates, rate indices, frequency of payments, delivery venues, the list goes on and on. Managing portfolios of risk requires large investments in risk systems, skilled personnel and infrastructure as well as large pools of dedicated capital. This dedicated capital, from some of the world's largest financial institutions, enables users of OTC derivatives to obtain very competitive pricing on tremendously large transactions. These users range from sovereigns, supranationals, corporations and investment firms to smaller companies and banks which are also able to take advantage of competitive pricing. These market making activities on the part of derivative dealers provide significant benefits to U.S. corporations and other end-users – benefits that are ultimately passed on to the broader economy and U.S. consumers.

Market Liquidity

With large pools of capital dedicated to making prices, users can transfer large amounts of risk, frequently in highly customized fashion, in a single transaction with minimal price disturbance.

Legal Certainty and Credit Risk Management

As shown in the previous section, the derivatives market amounts to hundreds of trillions of dollars of notional amounts. The industry has managed legal risk and counterparty credit risk by developing and using standardized contracts and confirmations, employing netting in over 50 countries and encouraging the use of collateral to cover market risk. Netting alone has reduced credit risk by 85%, according to the BIS, from nearly $25 trillion to less than $4 trillion and collateral has reduced it significantly more. The market could not possibly exist in its current state without these risk mitigants in place.

Confidentiality of Contracts

Derivative contracts are confidential agreements between two counterparties. This protects both the dealer that puts capital at risk as well as the client. The dealer can offset risk without a knowing market trading against its position. The client can protect its risk management or investment programs if they need to be executed over time as well as gain the benefit of better pricing because of the dealer's protection.

Weaknesses

In spite of its success and of its ability to provide the most flexible tools for risk management, the complexity and lack of transparency to regulators in the OTC derivatives market have been blamed for increasing systemic risk and for having an operational infrastructure that could be significantly improved. Critics of the OTC market have also cited lack of price transparency as a weakness. [9]

Complex Risks

The financial crisis revealed certain safety and soundness issues that OTC derivatives might create in financial markets. The first such issue was the extent of complex derivative risk in the marketplace – the AIG phenomenon. AIG was not alone, nor was this risk only taken in derivative form. Complex mortgage risk was taken by many market participants in cash as well as derivative form. This risk was not properly understood or managed by participants who bought the mortgage bonds or who provided the mortgage protection. Dealers who bought protection did not properly exercise appropriate counterparty risk management measures as the risks were much larger than expected.

---

[9] *Policy Perspectives on OTC Derivatives Market Infrastructure*, D Duffie, A Li, and T Lubke, *Federal Reserve Bank of New York Staff Reports*, no. 424

Interconnectivity - Systemic Risk

The second safety and soundness issue was the interconnectivity among dealers. Dealers have many points of transactional contact with other dealers, including, of course, OTC derivatives. It was not clear *a priori* how dealers might manage the risks of unwinding OTC derivatives positions they had with a defaulting dealer, even if the exposures were collateralized. Position and counterparty transparency was not available to the regulators. A related issue was the risks dealers posed to end users. Although material, this risk is not as large in aggregate. For example, the losses sustained by non-financial corporations in the Lehman bankruptcy that were solely caused by OTC derivatives were relatively modest: only four have filed claims in excess of $20 million against Lehman's derivative subsidiaries[10].

Operational Infrastructure

A different type of safety and soundness concern with OTC derivatives has always been present as a result of the infrastructure of the marketplace. Unlike exchanges, clearinghouses and other organized trading venues, the OTC derivatives market is what its name implies - over the counter. Each dealer and each user must construct its own infrastructure to manage its positions. The infrastructure ranges from accounting and payment systems to valuation models, collateral processes, portfolio reconciliations, etc. Regulators naturally believe one centralized family of systems is better than dozens, if not hundreds of independent families, any one of which could potentially create financial havoc if it failed.

Transparency

Most active users of OTC derivative products have access to dealers screens and vendor pricing services. In some OTC derivatives markets, customers may actually have access to pricing information comparable to the dealers as price aggregation services are available. However, because users do not see the prices where transactions are actually being executed, some users may be paying more than others for comparable products. To a large extent, users have not complained. They have become comfortable operating within the marketplace, soliciting prices from multiple dealers for virtually all their requirements. Nonetheless, additional transparency might be beneficial if it does not come at the cost of less liquidity and, therefore, higher prices. A related issue is ease of access to the marketplace. Should a market require participants to have multiple trading relationships if a central market can exist that requires only one such relationship?

Lack of transparency increases the room for market abuse and manipulation. In addition

[10] See http://chapter11.epiqsystems.com/LBH/claim/SearchClaims.aspx?rc=1

to needing transparency to monitor risk in the marketplace, regulators require transparency to prevent market abuse and manipulation.

Strengthening the Market - Execution Platforms

DFA addresses the significant safety and soundness issues primarily by requiring mandatory clearing for OTC derivatives as and when clearing becomes available. This will be required for all but non-financial end users. A similar proposal has been made to cover European markets. Clearing will not be available for complex derivatives as these products do not have the liquidity or standardization required for safe clearing. Complex risk will be visible through trade repository data (also mandated by DFA and its European equivalent) and better regulatory oversight. Trade repository data will also help regulators identify concentrations of counterparty and market risk.

Structural changes to the OTC derivatives marketplace that do not address safety and soundness need to be carefully constructed so as to preserve the market's strengths while addressing its weaknesses. When trade-offs need to be made, flexibility of approach is recommended to enable markets to adjust and remain liquid. Regulators have recognized that there are a number of different electronic trading models that could potentially be used for derivatives trading.[11] What then should a SEF be? In our view a SEF should be an effective marketplace offering derivative users broad choice in trade execution at very low cost. SEFs should be structured in ways such that end-users retain (and possibly increase) the flexibility they now have in executing trades and their access to the liquidity needed to effectively manage their risk. SEFs should:

- Provide maximum choice in trade execution to market participants. Members should not be constrained in their ability to implement their trading strategies by market rules;
- Provide pre- and post-trade transparency while maintaining liquidity.
- Have reasonable, tailored, and product specific block trade exemptions to preserve market liquidity;
- Grant access to a broad range of qualified market participants. Access rules should be objective and applied impartially;
- Have the ability to comply with the Core Principles[12]; and
- Have direct connectivity to trade data repositories.

It is also essential that individual SEFs are not discriminated against by central clearing organizations in terms of access and pricing.

---

[11] See *Report on Trading of OTC Derivatives* by the Technical Committee of The International Organizations of Securities Commissions (IOSCO), February 2011, for an excellent, comprehensive discussion.
[12] As defined in DFA.

III. The Markets for OTC Derivatives and for Futures Contracts

Market structures and practices evolve over time, driven by the needs of market participants. Where there is the potential for frequent trading of a financial (or commodity) asset, with a large number of buyers and sellers, one or more venues emerge to promote such trading by facilitating the execution of transactions by standardizing commercial terms, developing processes to complete transactions quickly and accurately and mitigating credit and other risks. Some of these markets evolve into exchanges. Much of the trading in futures contracts and a substantial portion of the trading in equities is now done on regulated exchanges. Successful exchange-traded products rely on relatively active order submission by many buyers and sellers creating high transaction flow.

Exchange-traded markets offer no guarantee of trading liquidity as evidenced by the high percentage of new exchange-listed products that regularly fail to enjoy active trading. For those contracts that do become liquid, exchanges allow a broad range of trading customers (including retail customers) meeting margin requirements to transact a small number of highly standardized contracts in relatively small amounts. As a result of the high number of market participants and the relatively small number of standardized instruments traded and the credit of a central counterparty clearer, liquidity in exchange-traded markets is relatively **continuous** in character. However, average ticket size is quite small and users often need to take significant market risk to execute large positions in smaller pieces over an extended period of time.

At the other end of the spectrum are markets such as those for OTC derivatives. Here, the number of potential buyers and sellers is relatively small, almost all of which are institutional, featuring a broader array of less-standardized products. Trades are typically much larger in size and much less frequent. Liquidity levels are highly variable and depend, to a very large extent, on a dealer making prices for clients. This, of course, is how the OTC derivatives markets started and remain today. Participants in these markets are very limited in number, almost all of them are institutions and they can obtain an almost endless variety of products. Trading in virtually all products is infrequent at best but the average size of trades dwarfs the size in the exchange-traded markets. Indeed, users often turn to the OTC markets because they cannot execute large enough size in the exchange-traded markets in one trade.

The table in the next page summarizes the main differences between the futures markets and the OTC derivatives markets.

OTC Swap Market vs Listed Futures Markets[13]

Characteristic	OTC Swaps	Listed Futures
Trading Counterparties	< 1,000	>> 100,000
Retail Participation	None	Significant
Daily Trades	< 20,000	> 1,000,000
Tradable Instruments	>> 100,000[14]	< 1,000
Trade Size	Very Large	Small
Market Structure	Bilateral (OTC)	Exchange

Of course, the two structures described above are not the only ones that have emerged. Trading in US treasuries for example, arguably one of the most liquid financial instruments in existence currently, is conducted in a number of marketplaces with different structures. Almost all of the trading in the so-called "on-the-run" treasuries, those most recently issued and most liquid, is conducted in electronic trading platforms like Tradeweb and BrokerTec where customers can access multiple large providers of liquidity. A substantial portion of trading in older, "off-the-run" treasuries is still done through wholesale brokers. Retail investors almost invariably trade with their brokerage. There is no requirement that any trades be made entirely on electronic platforms.

---

[13] See *Block Trade Reporting for Over-the-Counter Derivatives Markets*. ISDA/SIFMA January 18,2011.

[14] Inclusive of all tenors, strikes and duration.

IV. Swap Execution Facilities: Proposed Rules

Derivatives regulation is being addressed on a global basis. In the United States, DFA has been enacted. It delegates authority over the interest rate and commodity derivatives markets to the CFTC and the CDS and equity derivatives markets have been assigned to the SEC. (The CFTC also has responsibility for derivative products related to certain indices of credit and equity instruments). Across the Atlantic, the European Market Infrastructure Regulation ("EMIR") focuses on clearing and trade reporting while Markets in Financial Instruments Directive (MiFID) deals with, among other things, electronic trading requirements. The International Organization of Securities Commissions (IOSCO) has recently published a study[15] which analyzes the costs and benefits associated with increasing organized platform trading of derivatives. The study provides a comprehensive discussion of considerations that need to be addressed in making rules regarding electronic trading.

DFA

With respect to electronic trading, DFA requires that derivatives subject to mandatory clearing be executed on a SEF provided the derivative is made available for trading there. The electronic platform must be either a Designated Contract Market or a Swap Execution Facility. A SEF is "a trading system or platform in which multiple participants have the ability to execute or trade by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce".

DFA is intended to be implemented by rule-making of the CFTC and the SEC. The agencies must, of course, start with the plain language of the statute. In this respect, it does not appear that a single dealer platform could qualify as a SEF. While multiple parties might have the ability to execute through such a platform, they would not have the ability to accept bids or offers made by multiple participants. They could only deal with the dealer. Is this a reasonable outcome? It does facilitate access to competitive bids or offers but it is hard to see why every SEF must be created the same way. Real-time reporting (except for block trades) will provide transparency of pricing. As long as every participant that becomes a client of a member of a clearing house has access to a SEF that does permit multiple to multiple execution, it is hard to see the benefits of requiring every SEF to have this condition.

CFTC

The CFTC has issued[16] very specific rules regarding electronic trading. First, with respect to determining which products are available for trading, it delegates to the individual SEFs the

[15] Op. Cit.

[16] "Core Principles and Other Requirements for Swap Execution Facilities" published in the Federal Register on January 7, 2011 p 1214-1259.

determination of whether a derivative product was made available for trading. If one SEF has made that determination, all SEFs would be required to treat the swap as made available for trading as well. This poses a number of issues. It does not set out any specific criteria to determine whether a derivative product has the liquidity to trade. The IOSCO study points to two characteristics of products that need to be addressed in determining which products should migrate to platform trading. The two characteristics are standardization and liquidity. It goes on to set out elements of standardization and how to assess standardization using 10 different factors. It further examines liquidity, looking at the numbers and types of participants, each product's characteristics and transaction size and frequency. The CFTC does not specify such an assessment. The CFTC should state that a contract subject to mandatory clearing does not automatically make it available for trading and that the contract must also meet minimum liquidity and standardization characteristics.[17] The proposed rule creates a misalignment of interest, as SEFs will presumably be established as commercial enterprises. They will have every incentive to declare they have made a product available for trading in order to capture market share by steering trading onto their platform, even if the product trades very infrequently. Furthermore, if a product trades very infrequently and every trade executed is known to the entire market as a result of SEF execution, participants will be very cautious in taking on positions. The result will be less liquidity and worse pricing for users as the dealer-client relationship will have been needlessly damaged. The easiest way to eliminate this conflict of interest and its negative implications would be for the CFTC to make the "available to trade" determination - subject to public notice and comment.

A second proposal from the CFTC requires that SEFs either be Order Books or request for quote (RFQ) facilities. This is an unnecessarily narrow reading of the statute. It is difficult to see the advantage of requiring only two types of facilities to qualify as SEFs when other types of facilities might easily accomplish the goals of DFA. The CFTC further states that a participant utilizing a RFQ must send the request to at least five participants. This appears to be another example where the CFTC is being more precise and restrictive than it needs to be. The DFA states that participants must only have the ability to accept multiple bids or offers - not that they are required to ask for them. Requiring bids or offers from five dealers may make dealers hesitant to price the transaction aggressively as at least four other market participants will know of their winning position.[18] There may be other swaps that represent hedges for confidential transactions and should not be presented to five dealers. The five dealer requirement limits how

---

[17] IOSCO, Op. cit., p22.

[18] The SEC is aware of this problem: "However, broadly communicating trading interest, particularly about a large trade, may increase hedging costs, and thus costs to investors as reflected in the prices from the dealers." See 17 CFR Parts 240, 242 and 249 [Release No. 34-63825; File No. S7-06-11] *Registration and Regulation of Security-Based Swap Execution Facilities*, p17.

participants operate in markets when it does not serve clear purposes. The requirement is bound to reduce liquidity.

The CFTC indicates that all contract participants have impartial access to its markets and services. This seems to preclude a business model designed for wholesale participants only. The IOSCO study indicates that European regulators permit platform operators to categorize clients and to make rules appropriate for the category. This does mean that different clients may be treated in different ways. It does not seem necessary to prescribe that the business model of each SEF must ensure that all types of clients have equal access to it.

We also note that the proposed rule that each SEF know the full market position of every participant so that it is able to block any execution that would break a position limit appears to provide little value and, in this case, would be very difficult to implement.

SEC

The SEC has also proposed rules[19] that would govern OTC derivatives under its jurisdiction. The SEC approach is principles-based and is in general far less prescriptive than that of the CFTC. It does not specify that SEFs must either be Order Books or RFQs. It does not indicate how many participants must be asked for quotes. It does not require "unfettered access to any and all persons". The proposed rules require however that in SEFs "that operate both central limit and a separate RFQ mechanism, the SEF's systems would be required to ensure that any trade to be executed in the RFQ mechanism interacted with any existing firm interest on the central limit order book...". In addition, the SEC does require each SEF to know the full market position of every participant just as the CFTC does.

European Proposals

The European Commission has recently issued a consultation paper[20] outlining future policy initiatives regarding the Market in Financial Instruments Directive (MiFID). In it, the Commission considers, among other things, the issue of trading standardized OTC derivatives on exchanges or electronic trading platforms where appropriate, as part of its efforts to ensure efficient safe and sound derivatives markets. The approach is principles-based rather than prescriptive, pointing to a more flexible market environment than the U.S: "MiFID[21] is not prescriptive about where trades must be executed and provides flexibility and a choice for investors about where and how they wish to execute trades".

---

[19] Op. Cit.

[20] European Commission Public Consultation - *Review of The Markets In Financial Instruments Directive (MiFID)* 8 December 2010

[21] MiFID - Markets in Financial Instruments Directive

To address evolving market practices and technological developments and mitigate harmful regulatory arbitrage, the Commission proposes to introduce the concept of an *organised trading facility* with a broad definition in MiFID to suitably regulate all organized trading occurring outside the current range of MiFID venues. This definition would capture any facility or system operated by an investment firm or a market operator that, on an organized basis, brings together buying and selling interests or orders relating to financial instruments. This would cover facilities or systems whether bilateral or multilateral and whether discretionary or non-discretionary. Broker crossing systems and interdealer broker systems bringing together third-party interests and orders by way of voice and/or hybrid voice/electronic execution would qualify as organized trading facilities.

Under the proposals, all trading in derivatives eligible for central clearing and sufficiently liquid would be required to move either to regulated markets, Multilateral Trading Facilities (MTFs) or to the newly recognized organised trading facilities.[22]

[22] A Multilateral Trading Facility is a system that brings together multiple parties, institutional and/or retail that are interested in buying and selling financial instruments and enables them to do so. These systems can be crossing networks or matching engines that are operated by an investment firm or a market operator. Instruments may include shares, bonds and derivatives.

V. Recommendations

SEFs may play a positive role in the OTC derivatives market. They may strengthen the infrastructure of the market, help prevent insider trading and other market abuse as well as increase transparency and access to markets for smaller participants. Consistent with the provisions of DFA and with the principles listed in Section II above we recommend that:

- Rules should be flexible enough to allow business models to evolve over time;
- Participants in SEFs should not be constrained by an excessively rigid market structure;
- Products required to be traded in SEFs should be limited to liquid, mature products;
- Rules should not be simply imported from other non-analogous markets (futures, for example) but should take into account the nature of the derivative products traded and the relative sophistication of the market participants;
- Rules need to balance the rights and interests of the party attempting to execute a trade with broader transparency requirements;
- SEFs should not be burdened with the implementation and operation of complex supervisory functions such as monitoring the size of members' positions;
- "Available to Trade" determination should be made by regulators, not by the SEFs;
- Postings to any centralized price screens should be voluntary;
- Regulators should not mandate a specific trading method (Central Limit Order Book for example) for any product;
- SEFs should have discretion in developing their own trading structures;
- Regulators should not impose rules on the potential interaction between different execution platforms that may be offered by a SEF;
- The requirement that an RFQ must go to no less than five market participants might not be in the best interests of those initiating trades and should be dropped;
- The CFTC's fifteen second show rule does not bring incremental benefit to trade execution and should be scrapped;
- Reasonable exemptions should be made for the execution of "block" trades. Rules governing block trades should have each SEF determine whether a trade is a block trade or not. The SEF is best placed to review the swap and the block trade requirements and to make a determination about a block trade;
- Customers should be able to choose whether and to what extent they interact with resting orders on the SEF;
- The CFTC, SEC, and foreign regulators should cooperate and harmonize their approaches; and
- SEFs should be gradually phased-in given the need for the market to build the requisite infrastructure to connect to SEFs and for SEFs to connect to clearinghouses and swap data repositories.

We believe the implementation of these recommendations will be very helpful in addressing some of the weaknesses in the current market while preserving its strengths.

LETTER SUBMITTED BY STEPHEN MERKEL, CHAIRMAN, WHOLESALE MARKETS BROKERS' ASSOCIATION

WMBA AMERICAS
WHOLESALE MARKETS BROKERS' ASSOCIATION

June 3, 2010

The Honorable Gary Gensler	The Honorable Mary Schapiro
Chairman	Chairman
U.S. Commodity Futures Trading Commission	U.S. Securities and Exchange Commission
1155 21st Street, N.W.	100 F Street, N.E.
Washington, D.C. 20581	Washington, D.C. 20549-2001

Re: Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act; Core Principles and Other Requirements for Swap Execution Facilities (RIN 3038-AD18); Real-Time Public Reporting of Swap Transaction Data (RIN 3038–AD08); Reporting and Dissemination of Security-Based Swap Information (File 3235–AK80); Registration and Regulation of Security-Based Swap Execution Facilities (RIN 3235-AK93)

Dear Chairman Gensler and Chairman Schapiro:

As a follow-up to the participation of Wholesale Markets Brokers' Association Americas ("WMBAA")[1] members in the joint staff roundtable hosted by the Commodity Futures Trading Commission ("CFTC" or "Commission") and the Securities and Exchange Commission ("SEC" or "Commission") on May 3 and May 4, 2011 dedicated to discussing the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the WMBAA appreciates the opportunity to provide additional comments related to the importance of proper harmonization of and implementation by the two agencies as the rulemaking process advances.

The WMBAA believes that it is vital to the stability and liquidity provided by OTC swaps and security-based swaps (collectively referred to as "swaps") markets to ensure that swap and security-based swap execution facilities (collectively referred to as "SEFs") are brought under the new regulatory regime in such a way that fosters the competitive nature of OTC markets and continues to provide a deep source of liquidity for market participants.

In addition to the formal comments previously submitted with respect to the CFTC and SEC's proposed rules,[2] the WMBAA offers additional comments on the appropriate implementation of the

---

[1] The Wholesale Markets Brokers' Association Americas is an independent industry body representing the largest inter-dealer brokers ("IDBs") operating in the North American wholesale markets across a broad range of financial products. The WMBAA and its member firms have developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets.* Using these principles as a guide, the Association seeks to work with Congress, regulators and key public policymakers on future regulation and oversight of over-the-counter ("OTC") markets and their participants. By working with regulators to make OTC markets more efficient, robust and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country's capital markets. For more information, please see www.wmbaa.org.

[2] *See, e.g.,* letter from J. Christopher Giancarlo, Chairman, WMBAA, to SEC and CFTC, dated July 29, 2010; *see also* letter from Julian Harding, Chairman, WMBAA, to SEC and CFTC, dated November 19, 2010; letter from Julian Harding, Chairman, WMBAA, to SEC and CFTC, dated November 30, 2010; letter from Julian Harding, Chairman, WMBAA, to SEC, dated January 18, 2011; letter from Stephen Merkel, Chairman, WMBAA, to CFTC, dated February 7, 2011; letter from Stephen Merkel, Shawn Bernardo, Christopher Ferreri, J. Christopher Giancarlo and Julian Harding, WMBAA, to CFTC, dated April 4, 2011.

proposed rules and substantive requirements that would pose significant burdens unless harmonized between the CFTC and SEC.

The WMBAA also recognizes that certain provisions of the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("1934 Act"), as amended by the Dodd-Frank Act, impose specific requirements on market participants as of the effective date, July 16, 2011. In particular, we note the statutory provisions could be read to require on and after July 16, 2011 the "trading" of swaps only on registered designated contract markets ("DCMs"), national securities exchanges and SEFs.

Congress envisioned that the Title VII rulemaking process would move quickly and that all rules and regulations would be in place prior to the July 16, 2011 effective date. It is clear that final rules for the registration of SEFs will not be in place by the July 16, 2011 effective date. Further, the Commissions have not made any determinations about which swaps will be subject to the mandatory clearing requirement, which will dictate which swaps are required to be traded on a SEF.

The WMBAA is concerned that, absent regulatory relief by the Commissions, existing trade execution systems or platforms such as those provided by WMBAA members, and the swaps transactions entered into thereon will be subject to significant legal uncertainty due to the incomplete rulemaking process. Further, we believe IDBs should not be required to register as futures commission merchants ("FCMs"), introducing brokers ("IBs") or broker-dealers to "broker" swaps while the Commissions are in the process of finalizing the SEF registration and regulation rules.[3] The WMBAA strongly encourages the Commissions to issue as soon as possible a legal opinion, no action position or guidance which clarifies that swaps entered into after July 15, 2011 are not required to be traded on a registered DCM, national securities exchange and/or SEF or brokered by a registered FCM, IB or broker-dealer until the Commissions have issued final rules which are effective regarding the registration of SEFs and issued final rules which are effective with respect to the mandatory trading of swaps. The WMBAA looks forward to discussing the impact of the self-effectuating provisions in the CEA and 1934 Act with the Commissions.

Importance of Harmonization between Agencies and Foreign Regulators

While the substance of the proposed requirements for SEF registration and core principles are extremely important, it is equally, if not more, important that the final regulatory frameworks are harmonized between the two agencies. A failure to achieve harmonization will lead to regulatory arbitrage and unreasonably burden market participants with redundant compliance requirements. As the recent SEC-CFTC joint proposed rule recognized, "a Title VII instrument in which the

[3] The WMBAA notes that, among the extensive Dodd-Frank Act rulemakings, the CFTC has not comprehensively addressed the regulation of brokers engaged in swap-related activities. Section 721 of the Dodd-Frank Act amends the definitions of "futures commission merchants" and "introducing brokers" in the CEA to permit these intermediaries to trade swaps on behalf of customers. As of the effective date, these intermediaries may be required to register with the CFTC and become members of the National Futures Association. As such, these intermediaries would be subject to the National Futures Association's rules and examinations, for example Series 3 examination, which is based on futures-related activity. The WMBAA urges the CFTC to provide clarity on this issue by delaying the implementation of swap introducing broker and futures commission merchant registration and issuing interpretive guidance to assist swap intermediaries in understanding what activities might mandate registration and the requirements for Commission registration.

underlying reference of the instrument is a "narrow-based security index" is considered a security-based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (*i.e.*, the index is broad-based), the instrument is considered a swap subject to regulation by the CFTC."[4] Any discrepancy in the Commissions' regulatory regimes will give market participants incentive to leverage the slight distinctions between these products to benefit from more lenient rules.

The Dodd-Frank Act's framework was constructed to encourage the growth of a vibrant, competitive marketplace of regulated SEFs. Final rules should be crafted that encourage the transaction of OTC swaps on these trading systems or platforms, as increased SEF trading will increase liquidity, and transparency for market participants and increase the speed and accuracy of trade reporting to swap data repositories ("SDRs"). Certain provisions relate to these points, such as the permitted methods of trade execution, the scope of market entities granted impartial access to SEFs, the formulation of block trade thresholds and compliance with SEF core principles in a flexible manner that best recognizes the unique characteristics of competitive OTC swaps markets.

Based upon its review of both the SEC and the CFTC's Proposed Rules, the WMBAA suggests that the agencies consider the release of further revised proposed rules incorporating comments received for additional review and comment by market participants. This exercise would ensure that the SEC and CFTC have the opportunity to review each of their proposals and integrate appropriate provisions from the proposed rules and comments in order to arrive at more comprehensive regulations. Further, the WMBAA encourages the CFTC and SEC to work together to attempt to harmonize their regulatory regimes to greatest extent possible. While some of the rules will differ as a result of the particular products subject to each agency's jurisdiction, inconsistent rules will make the implementation for SEFs overly burdensome, both in terms of time and resources.

As an example, the WMBAA encourages the CFTC and the SEC to adopt one common application form for the registration process. While regulatory review of the application by the two agencies is appropriate, reducing the regulatory burden on applicant SEFs to one common form would allow for a smoother, timelier transition to the new regulatory regime. Because the two proposed registration forms are consistent in many respects, the WMBAA believes the differences between the two proposed applications could be easily reconciled to increase regulatory harmonization and increase efficiency.

Similarly, there needs to be a consistent approach with respect to block trades. Not only should the threshold calculations be derived from similar approaches, allowing for tailored thresholds that reflect the trading characteristics of particular products, but the methods of trade execution permitted by the Commissions should both be flexible and within the framework of the SEF definition.

U.S. regulations also need to be in harmony with regulations of foreign jurisdictions to avoid driving trading liquidity away from U.S. markets toward markets offering greater flexibility in modes of trade execution. In particular, European regulators have not formally proposed swap execution rules with proscriptive limits on trade execution methodology. We are not aware of any significant regulatory

[4] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. at 29, 845 (May 23, 2011).

efforts in Europe to mandate electronic execution of cleared swaps by institutional market participants.

In a world of competing regulatory regimes, business naturally flows to the market place that has the best regulations – not necessarily the most lenient, but certainly the ones that have the optimal balance of liquidity, execution flexibility and participant protections. In an OTC swaps market that excludes retail participants, the WMBAA questions what useful protections are afforded to swap dealers and major swap participants by regulations that would limit the methods by which they may execute their orders. U.S. regulations need to be in harmony with regulations from foreign jurisdictions to avoid driving trading liquidity away from U.S. markets towards markets offering greater flexibility in modes of trade execution.

Implementation of Final Rules

Compliance Timeline

The WMBAA believes that the timeline for implementation of the final rules is as important, if not more important than, the substance of the regulations. The WMBAA members recognize and support the fundamental changes to the regulation of the OTC swaps markets resulting from the passage of the Dodd-Frank Act and will commit the necessary resources to diligently meet the new compliance obligations. However, the CFTC and SEC must recognize that these changes are significant and will result in considerable changes to the operations and complex infrastructure of existing trading systems and platforms.

It is necessary that any compliance period or registration deadline provides sufficient opportunity for existing trade execution systems or platforms to modify and test systems, policies and procedures to ensure that its operations are in compliance with final rules. It is very difficult to determine the amount of time needed to ensure compliance with the rules until the final requirements are made available. However, providing market participants with an insufficient time frame for compliance could harm the efficient functioning of the markets if existing entities can no longer operate until they have built the requisite platforms to comply with every measure in final rules.

The vast number of changes required to existing trading systems or platforms to register as a SEF will impose a substantial burden in the short term. Upon implementation of the Dodd-Frank Act and final rules, wholesale brokers that register as SEFs will be required to undertake activities that include, but are not limited to: (i) developing extensive rulebooks; (ii) meeting new substantive and reporting-related financial requirements; (iii) implementing sophisticated trading, surveillance, monitoring and recordkeeping processes and technology; (iv) creating extensive self-regulatory capabilities and entering into arrangements with their customers setting forth the terms of this new arrangement; (v) potentially restructuring the governance structure of their companies, including identifying and recruiting independent board members and establishing required governance committees; (vi) potentially altering the mix of their existing customer base and adding new customers; (vii) implementing appropriate contractual and technological arrangements with clearing houses and SDRs; (viii) hiring staff and creating a compliance program structured to meet the Commissions' specifications; and (ix) educating staff on the requirements relating to trade execution, clearable vs. non-clearable trades, blocks vs. non-blocks, bespoke and illiquid trades, end users vs. non-end users and margin requirements.

As this list indicates, these undertakings are monumental. This burden is compounded when considering that the users of intermediary services will themselves be going through dramatic change, responding to new clearing, margin and capital requirements, new business conduct standards and changes to the means by which they are able to interact with their end customers. The WMBAA would suggest the SEC and CFTC consider the implementation of other regulatory regimes with lesser burdens than the Dodd-Frank Act, such as the introductions of TRACE reporting for corporate bonds and Regulations SHO and NMS in the equity markets. The imposition of these new regimes was far less drastic of a change to the markets and required participants to expend far fewer resources. Yet, the imposition of these regimes, particularly Regulation NMS, was conducted over a staged period to allow market participants sufficient time to comply.

Appropriate "Phasing" of Final Rules

Based upon the plain language of the Dodd-Frank Act, the mandatory trade execution requirement will become effective at the time that swaps are deemed "clearable" by the appropriate Commission. Accepting the premise that the mandatory trade execution requirement cannot be enforced until there are identified "clearable" swaps and swaps are "made available for trading," the Commissions need to ensure that a functioning and competitive marketplace of registered SEFs exists at the time the first trade is cleared and made available for trading. As such, it is necessary that SEFs be registered with the CFTC or SEC, as applicable and available to execute transactions at the time that trades begin to be cleared under the new laws. The WMBAA estimates that its members currently account for over 90% of inter-dealer intermediated swaps transactions taking place around the world today. If the SEF registration process is not effectively finalized by the time various swaps are deemed clearable, there could be serious disruptions in the U.S. swaps markets with adverse consequences for broader financial markets.

Furthermore, requiring absolute compliance with final rules within a short time frame is particularly troublesome for likely future SEFs, as such a result may provide DCMs or national securities exchanges with an unfair advantage in attracting trading volume due to their ability to quickly meet the regulatory burdens. Congress distinguished between exchanges and SEFs, intending for competitive trade execution to be made available on both platforms. Congress also recognized the importance of SEFs as distinct from exchanges, noting that a goal of the Dodd-Frank Act is to promote the trading of swaps on SEFs. The phasing in of final rules for both exchanges and SEFs should be done concurrently to ensure that this competitive landscape remains in place under the new regulatory regime.

Not only will implementation of the final rules impact market infrastructure, but the timing in which these rules are implemented could significantly impact U.S. financial markets. As Commissioner Jill Sommers recently remarked before the House Agriculture General Farm Commodities and Risk Management Subcommittee, "a material difference in the timing of rule implementation is likely to occur, which may shift business overseas as the cost of doing business in the US increases and create other opportunities for regulatory arbitrage."[5] If the U.S. regulations are implemented before

[5] Statement of Jill E. Sommers before the Subcommittee on General Farm Commodities and Risk Management, House Committee on Agriculture, May 25, 2011, available at http://agriculture.house.gov/pdf/hearings/Sommers110525.pdf.

foreign regulators have established their intended regulatory framework, it could put U.S. markets at a significant disadvantage and might result in depleted liquidity due to regulatory arbitrage opportunities.

As the rulemaking process moves forward, the WMBAA suggests the following progression of rules be completed:

- First, finalize product definitions. Providing the market with certainty related to the scope of what constitutes a "swap" and "security-based swap" will allow market participants to accurately gauge the impact of the other proposed rules and provide constructive feedback on those rules.
- Second, implement final rules related to real-time reporting for regulatory oversight purposes. The submission of information to SDRs is an activity that takes place in many OTC markets today and will not unduly burden those who must comply with the requirement. Ensuring that the Commissions receive current, accurate market data is a cost-effective method to mitigate systemic risk in the short-term.
- Next, establish block trade thresholds and finalize public reporting rules. The information gathered by SDRs since the implementation of the mandatory trade reporting requirement, along with historical data made available by trade repositories and trade execution facilities, can be used to determine the appropriate threshold levels on a product-by-product basis. At the same time, public reporting rules can be put into place, including an appropriate time delay (that is consistent with European and the other major global market rules) for block trades.
- After the reporting mechanics have been established, the clearing mandate can be implemented. During this step, the Commissions can determine what swaps are "clearable" and subject to the clearing mandate, and clearinghouses can register and begin to operate within the new framework.
- Finally, once swaps are deemed clearable, the mandatory trade execution requirement can be put into place for SEFs and DCMs for those products made available for trading. The WMBAA believes that all clearable swaps will be made available for trading by SEFs, as these trade execution platforms compete to create markets and match counterparties. With the trade execution requirement's implementation, it is imperative that rules for SEFs and DCMs are effective at the same time, as implementing either entity's rules prior to the other will result in an unfair advantage for capturing market share of executable trades simply because they could more quickly meet the regulatory burdens.

Flexible Approach to SEF Registration, Permitted Modes of Trade Execution, Impartial Access

The WMBAA members have long acted as intermediaries in connection with the execution of swaps in the OTC market. While a regulated OTC market is new to the swap markets, the WMBAA members are already subject to oversight by financial regulators across the globe, including the SEC and the CFTC, for services offered in a range of other products and markets. The WMBAA members have acted as OTC swap execution platforms for decades and, as a result, understand what is necessary to support and promote a regulated, competitive and liquid swaps market. Although a SEF might be a new concept originating in the Dodd-Frank Act, the effective role of existing intermediaries in the OTC swaps marketplace is not.

The WMBAA supports a flexible approach to evaluating applicant SEFs. As Congress recognized and mandated by law, to promote a competitive and liquid swaps market, trade execution "through any means of interstate commerce" establishes a broad framework that permits multiple modes of swap execution, so long as the proposed mode of execution is capable of satisfying the statutory requirements.

The WMBAA believes that any interpretation of the SEF definition must be broad, and any trading system or platform that meets the statutory requirements should be recognized and registered as a SEF. The WMBAA supports a regulatory framework that allows any SEF applicant that meets the statutory requirements set forth in the Dodd-Frank Act to be permitted to operate under each Commission's rules in accordance with the Dodd-Frank Act.

The WMBAA strongly supports the SEC's interpretation of the SEF definition as it applies to trade execution through any means of interstate commerce, including request for quote systems, order books, auction platforms or voice brokerage trading, because such an approach is consistent with the letter and spirit of the Dodd-Frank Act and ensures flexibility in the permitted modes of execution. The WMBAA believes that this approach should be applied consistently to all trading systems or platforms and will encourage the growth of a competitive marketplace of trade execution facilities.

Further, the WMBAA is concerned with the CFTC's interpretation of the SEF definition, as it limits the permitted modes of trade execution, specifically restricting the use of voice-based systems to block trades. The SEF definition and corresponding requirements on the CEA, as amended by the Dodd-Frank Act, do not provide any grounds for this approach and will severely impair other markets that rely on voice-based systems (or hybrid systems, which contain a voice component) to create liquidity.

Permitted Use of Voice and Hybrid Trade Execution Platforms

The CFTC's proposed mandate precludes the use of voice-based systems for "Required Transactions" without any explanation of why the permitted modes of execution should be more restrictive than the statute dictates. The WMBAA is concerned that such a rigid implementation of the SEF framework will devastate existing voice and "hybrid" systems (described below) that are currently relied upon for liquidity formation in global swaps markets. "Hybrid brokerage," which integrates voice with electronic brokerage systems, should be clearly recognized as an acceptable mode of trade execution, for all swaps trade execution. The combination of traditional "voice" brokers with sophisticated electronic trading and matching systems is necessary to provide liquidity in markets for less commoditized products where liquidity is not continuous. Failure to unambiguously include such systems is not only inconsistent with the Dodd-Frank Act but will severely limit liquidity production for a wide array of transactions. The WMBAA remains concerned that such a restrictive SEF regime will lead to market disruption and, worse, liquidity constriction with adverse consequences for vital U.S. capital markets.

What determines which blend of hybrid brokerage is adopted by the markets for any given swap product is largely the market liquidity characteristic of that product, whether or not the instrument is cleared. For example, a contract to trade Henry Hub Natural Gas delivered in Summer 2017, though cleared, will generally be insufficiently liquid to trade on a central limit order book. This is true the farther out the delivery date for many cleared products, where market makers are unwilling to post executable bids and offers in instruments that trade infrequently. In markets where price spreads are wide or trading is infrequent, central limit order books are not conducive to liquidity, but rather may be disruptive to it.

Critically, what determines which blend of hybrid brokerage is adopted by the markets for any given swap product also has little to do with whether the size of a transaction is sufficient or not to be a block trade. Block trades concern the size of an order, as opposed to the degree of market liquidity or presence of tight bid-offer spreads. Depending on where block trade thresholds are set, block trades can take place in markets from very illiquid to highly liquid. Yet, central limit order book trade execution generally only works well in markets with deep liquidity, and such liquidity is not always available even within a usually liquid market. For less liquid markets, even non-block size trades depend on a range of trading methodologies distinct from central limit order book or request for quote. For these reasons, hybrid brokerage should be clearly recognized as an acceptable mode of trade execution for all swaps whether "Required" or "Permitted."

In addition, the regulatory framework for the swaps market must take into consideration the significant differences between the trading of futures on an existing exchange and the trading of swaps on SEF platforms. While it may be appropriate, in certain instances, to look to the futures model as instructive, overreliance on that model will not achieve Congress' goal. Congress explicitly incorporated a SEF alternative to the exchange-trading model, understanding that competitive execution platforms provide a valuable market function. Final rules governing SEFs should reflect Congressional intent and promote the growth of existing competitive, vibrant markets without impeding liquidity formation.

Impartial Access to SEFs

The WMBAA is concerned that the CFTC's proposed mandate that SEFs provide impartial access to independent software vendors ("ISVs") is beyond the legal authority in the CEA because it expands the impartial access provision beyond "market participants" to whom access is granted under the statute. Moreover, because SEFs are competitive execution platforms, a requirement to provide impartial access to market information to ISVs who lack the intent to enter into swaps on a trading system or platform will reduce the ability for market participants to benefit from the competitive landscape that provides counterparties with the best possible pricing. Further, given the lack of a definition of what constitutes an ISV and the significant technological investments made by wholesale brokers to provide premiere customer service, the ISV impartial access requirement leaves open the possibility that SEFs could qualify as ISVs in order to seek access to competitors' trading systems or platforms. This possibility would defeat the existing structure of competitive sources of liquidity, to the detriment of market participants, including commercial end users. The WMBAA strongly urges the CFTC to carefully consider the SEC's impartial access proposal, which is well aligned with both the express statutory provisions and the broader goals of Title VII of the Dodd-Frank Act to promote a marketplace of competing swaps execution venues.

The WMBAA also believes the SEC should review its proposed impartial access provisions to ensure that impartial access to the SEF is different for competitor SEFs or national exchanges than for registered security-based swap dealers, major security-based swap participants, brokers or eligible contract participants. Congress clearly intended for the trade execution landscape after the implementation of the Dodd-Frank Act to include multiple competing trade execution venues, and ensuring that competitors cannot access a SEF's trading system or platform furthers competition, to the benefit of the market and all market participants.

Interim or Temporary SEF Registration

The implementation of any interim or temporary registration relief must be in place for registered trading systems or platforms at the time that swaps are deemed "clearable" by the Commissions to allow such platforms to execute transactions at the time that trades begin to be cleared. Interim or temporary registration relief would be necessary for trading systems or platforms if sequencing of rules first addresses reporting to SDRs and mandatory clearing prior to the mandatory trade execution requirement. The WMBAA strongly encourages the Commission to provide prompt provisional registration to existing trade execution intermediaries that intend to register as a SEF and express intent to meet the regulatory requirements within a predetermined time period. To require clearing of swaps through derivatives clearing organizations without the existence of the corresponding competitive trade execution venues risks consistent implementation of the Dodd-Frank Act and could have a disruptive impact on market activity and liquidity formation, to the detriment of market participants.

At the same time, a temporary registration regime should ensure that trade execution on SEFs and exchanges is in place without benefitting one execution platform over another. Temporary registration for existing trade execution platforms should be fashioned into final rules in order to avoid disrupting market activity and provide a framework for compliance with the new rules. The failure of the Commission to provide interim or temporary relief for existing trading systems or platforms may alter the swaps markets and unfairly induce market participants to trade outside the U.S. or on already-registered and operating exchanges.

The 15 Second Rule

Finally, there does not appear to be any authority for the CFTC's proposed requirement that, for "Required Transactions," SEFs must require that traders with the ability to execute against a customer's order or execute two customers against each other be subject to a 15 second timing delay between the entry of those two orders ("15 Second Rule"). One adverse impact of the proposed 15 Second Rule is that the dealer will not know until the expiration of 15 seconds whether it will have completed both sides of the trade or whether another market participant will have taken one side. Therefore, at the time of receiving the customer order, the dealer has no way of knowing whether it will ultimately serve as its customer's principal counterparty or merely as its executing agent. The result will be greater uncertainly for the dealer in the use of its capital and, possibly, the reduction of dealer activities leading, in turn, to diminished liquidity in and competitiveness of U.S. markets with costly implications for buy-side customers and end users.

While this delay is intended by the Commission to ensure sufficient pre-trade transparency, under the CEA, transparency must be balanced against the liquidity needs of the market. Once a trade is completed when there is agreement between the parties on price and terms, any delay exposing the parties to that trade to further market risk will have to be reflected in the pricing of the transaction, to the detriment of all market participants.

Ensuring that Block Trade Thresholds are Appropriately Established

As noted in previous remarks submitted to each Commission, from the perspective of intermediaries who broker transactions of significant size between financial institutions it is critical that the block trade threshold levels and the reporting regimes related to those transactions are established in a manner that does not impede liquidity formation. A failure to effectively implement block trading thresholds will frustrate companies' ability to hedge commercial risk. Participants rely on swaps to appropriately plan for the future, and any significant changes to market structure might ultimately inhibit economic growth and competitiveness.

Establishing the appropriate block trade thresholds is of particular concern for expectant SEFs because the CFTC's proposal regarding permitted modes of execution restricts the use of voice-based systems solely to block trades. While WMBAA believes that this approach is contrary to the SEF definition (as discussed herein and in previous letters), which permits trade execution through any means of interstate commerce, this approach, if combined with block trade thresholds that are too high for the particular instrument, would have a negative impact on liquidity formation.

With respect to block trade thresholds, the liquidity of a market for a particular financial product or instrument depends on several factors, including the parameters of the particular instrument, including tenor and duration, the number of market participants and facilitators of liquidity, the degree of standardization of instrument terms and the volume of trading activity. Compared to commoditized, exchange-traded products and the more standardized OTC instruments, many swaps markets feature a broader array of less-commoditized products and larger-sized orders that are traded by fewer counterparties, almost all of which are institutional and not retail. Trading in these markets is characterized by variable or non-continuous liquidity. Such liquidity can be episodic, with liquidity peaks and troughs that can be seasonal (*e.g.*, certain energy products) or more volatile and tied to external market and economic conditions (*e.g.*, many credit, energy and interest rate products).

As a result of the episodic nature of liquidity in certain swaps markets combined with the presence of fewer participants, the WMBAA believes that the CFTC and SEC need to carefully structure a clearing, trade execution and reporting regime for block trades that is not a "one size fits all" approach, but rather takes into account the unique challenges of fostering liquidity in the broad range of swaps markets.

Such a regime would provide an approach that permits the execution of transactions of significant size in a manner that retains incentives for market participants to provide liquidity and capital without creating opportunities for front-running and market distortion.

To that end, the WMBAA supports the creation of a Swaps Standards Advisory Committee ("Advisory Committee") for each Commission, comprised of recognized industry experts and representatives of registered SDRs and SEFs to make recommendations to the Commissions for appropriate block trade thresholds for swaps. The Advisory Committee would (i) provide the Commissions with meaningful statistics and metrics from a broad range of contract markets, SDRs and SEFs to be considered in any ongoing rulemakings in this area and (ii) work with the Commissions to establish and maintain written policies and procedures for calculating and publicizing block trade thresholds for all swaps reported to the registered SDR in accordance with the criteria and formula for determining block size specified by the Commissions.

The Advisory Committee would also undertake market studies and research at its expense as is necessary to establish such standards. This arrangement would permit SEFs, as the entities most closely related to block trade execution, to provide essential input into the Commissions' block trade determinations and work with registered SDRs to distribute the resulting threshold levels to SEFs. Further, the proposed regulatory structure would reduce the burden on SDRs, remove the possibility of miscommunication between SDRs and SEFs and ensure that SEFs do not rely upon dated or incorrect block trade thresholds in their trade execution activities. In fact, WMBAA members possess historical data for their segment of the OTC swap market which could be analyzed immediately, even before final rules are implemented, to determine appropriate introductory block trade thresholds, which could be revised after an interim period, as appropriate.

Conclusion

The WMBAA thanks the Commissions for the opportunity to comment on these very important issues. We look forward to continuing our conversations with the Commissioners and staff as the new regulatory framework is developed and implemented in a way that fosters competition and liquidity for market participants.

Please feel free to contact the undersigned with any questions you may have on our comments.

Sincerely,

Stephen Merkel

Stephen Merkel, Chairman