HEARING TO REVIEW THE IMPACT OF G20 CLEARING AND TRADE EXECUTION REQUIREMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

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WITNESSES

HEARING TO REVIEW THE IMPACT OF G20 CLEARING AND TRADE EXECUTION REQUIREMENTS

TUESDAY, JUNE 14, 2016

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 1300 of the Longworth House Office Building, Hon. Austin Scott of Georgia [Chairman of the Subcommittee] presiding.

Members present: Representatives Austin Scott of Georgia, Lucas, Neugebauer, Rogers, LaMalfa, Davis, Kelly, Conaway (*ex officio*), David Scott of Georgia, Vela, Kirkpatrick, Aguilar, and Peterson (*ex officio*).

Staff present: Caleb Crosswhite, Darryl Blakey, Kevin Webb, Paul Balzano, Stephanie Addison, Faisal Siddiqui, John Konya, Liz Friedlander, Matthew MacKenzie, Nicole Scott, and Carly Reedholm.

STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA

The CHAIRMAN. Good morning. This hearing of the Committee on Agriculture, to review the impact of G20 clearing and trade execution requirements, will come to order.

Good morning. Thank you for joining the Commodity Exchanges, Energy, and Credit Subcommittee for our last installment of our three-part hearing series examining the implementation of the derivatives market reforms envisioned by world leaders following the 2008 global financial crisis. Today, we will wrap up the series with a focus on clearing and trade execution requirements.

Throughout this series, we have reiterated many times that our goal is not an indictment of the reform objectives, but rather an analysis of its implementation by United States regulators and the interaction of the U.S. regulatory regime with that of other global jurisdictions. A vibrant and resilient derivatives marketplace is crucial for the market participants and end-users who rely on it to manage their diverse business risks. It is also critical for the consumers, Americans in the Eighth District of Georgia and across the nation, who rely on the price stability afforded by these risk management practices.

Crucially, the global nature of this marketplace cannot be taken for granted. Regulations must not unnecessarily fragment the market, defining liquidity pools by borders instead of market needs. We have already had many conversations on cross-border equivalence and recognition in the clearing space.

While we are encouraged by recent steps toward U.S.-EU regulatory harmonization of clearinghouses, applications to European Securities and Market Authority for U.S. clearinghouses to be recognized remain outstanding with a quickly approaching deadline. I am told this will be done soon, but this process has taken far too long.

Equivalence recognition and substituted compliance decisions must be resolved more quickly. Regulators need to be working now to prevent similar protracted negotiations for trade execution facilities in the future.

We are glad to have witnesses before us today who can expound on the changes to the clearing ecosystem. While transaction clearing has long played a role in the marketplace, Dodd-Frank swaps clearing mandate has significantly expanded the volume of cleared transactions. I am sure that the insights and perspectives offered today will be vital as we think through the related implications of resilience and recovery of clearinghouses in times of market stress. Many questions have been raised about the workability of the CFTC's trade execution rules. Do they accurately reflect Congressional intent, and sufficiently take into account the intricacies of the marketplace they regulate, do they restrict market access for the end-users who need to meet specific and custom hedging needs, and perhaps most importantly, do they impose arbitrary barriers to trading that diminishes liquidity? We look forward to exploring these and other issues more deeply today.

In developing their market reform framework, G20 leaders were clear about the need for global regulators to collaborate and coordinate on these rules. They saw consistent implementation of reforms as preventing regulatory arbitrage, protecting financial stability, and promoting competition and innovation. This too is the standard by which we measure our regulatory progress.

With that, I want to welcome our panel of accomplished witnesses who bring their diverse viewpoints on clearing and trade execution. Thank you each for the time and effort you put into being here today. We look forward to leaving here with a deeper understanding of the issues at hand.

[The prepared statement of Mr. Austin Scott follows:]

PREPARED STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

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The CHAIRMAN. And I will recognize our Ranking Member, Mr. Scott, for any remarks he would like to make.

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you, Chairman Scott. It is a pleasure to be here. This is indeed an important and very timely hearing.

As we know, the derivatives and swaps market that we are dealing with is an $600+ trillion piece of the world's economy. It is very complex, complicated, and oftentimes all too confusing. So I thought we might give just a little background to sort of set the stage for how we got here.

As you all remember, after the financial crisis the derivatives markets were dramatically transformed by Title VII in the Dodd-Frank Act. And Title VII falls directly under the purview of this Committee. It is a section relating to derivatives, the large swaths of CFTC and SEC mandates. These are our regulators in this area. And one of our major concerns is to make sure that our two regulatory agencies themselves can harmonize and make sure, and that is a very important mandate for our Committee to make sure of. This included rulemakings pertaining to clearing, trade executions, reporting, and transparency obligations.

Then we come back a little earlier in 2009, the G20 proposed reforms to the derivatives markets with a particular emphasis on making sure a global standard is met so that harmonization in our rules could be met. The United States' response to this G20 summit was Dodd-Frank, while other countries have implemented their own laws with varying timelines, which creates another problem. This mismatch in timing has led to a slew of equivalency problems, none greater than what is happening in the European Union. For example, the EU will soon implement a rule that is not, and could not be as strong as the United States' rule. And given the global nature of our world's derivatives markets, equivalency problems have led to many market participants going from one place to another.

And so on Tuesday, May 24, the CFTC issued a final rule that applies to the Commission's margin requirements for uncleared swaps in the context of cross-border transactions. This rule would limit the ability of banks and other traders to move swaps businesses abroad to avoid U.S. trading requirements. And this is something we need to hear from you, how it impacts our industry. The rule requires that offshore units of U.S. banks adhere to CFTC margin rules, even in cases where the unit's American parents aren't explicitly off the hook for trades.

Now, just to refresh your memory, swaps did get a bad name during the financial crisis because of a certain swap called the credit default swap. It is a key over-the-counter derivative. During that crisis, if you recall, AIG issued a huge amount of CDS contracts, paying out similar to an insurance contract, when collateralized debt obligations collapsed. This was hugely speculative, and has since been corrected because a version of it has been targeted by U.S. policymakers for greater oversight and transparency because they played a central role in the financial crisis.

So we come to December 2015. Now, CFTC finalized rules to set collateral or margin requirements on trade between swap dealers and other firms that aren't done through clearinghouses. This is what is referred to as uncleared swaps, and makes a multi-trillion dollar swaps market that isn't backed by a central clearinghouse. However, this December 25 rule did not set guidelines for cross-border swaps. As written, the swaps were guaranteed by the foreign counterparty, the swaps were exempt from U.S. margin requirements, and because of this, U.S. banks have been restructuring their contracts to de-guarantee these swap transactions, and any liability for these swaps would then lie solely with the offshore operation. Now, most of this was moved to London.

And so now, we are in a situation where we want to hear from you pertaining to this rule, and to share with this Committee concerns that you in the industry have. Regardless of what we do here, it is you, it is the clearinghouses, it is the market participants who have to make all of this work.

So, Mr. Chairman, I look forward to a good hearing, an important and timely hearing, and thank you for the time.

The CHAIRMAN. Thank you, Mr. Scott. And I understand Mr. Peterson, the Ranking Member of the full Committee, has a statement that he would like to be recognized to make.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman. And I will be brief. And I want to thank the panel of witnesses for joining us today.

When we wrote Title VII of Dodd-Frank, we incorporated goals set by the G20 in response to the market's failure. We also took into account the risks posed by an opaque, top-heavy swaps market. We required standardized swaps to be cleared and to be traded in an environment, with multiple market participants making both bids and offers. That clearing requirement has now been met and we have brought stability to the market.

I am looking forward to discussing the trade execution issue today because I don't believe we have achieved the goal that we set in Dodd-Frank in terms of the way that swaps are traded. Not much has changed. In some ways, the marketplace is worse now than it was before the crisis. The four largest dealers control 90 percent of all the swaps traded. The pre-crisis market structure, where they served clients in one market, and deal nearly exclusively with each other in the secondary market, still exists. So I hope today's hearing can help us understand why this is the case, and I look forward to your testimony. I yield back my time.

The CHAIRMAN. The chair would remind other Members to submit their opening statements for the record so the witnesses may begin their testimony, and to ensure that there is ample time for questions.

I would like to welcome our witnesses to the table. First, we have the Honorable Terrence Duffy, Executive Chairman and President of the CME Group, from Chicago, Illinois. We have Mr. Christopher Edmonds, Senior Vice President, Financial Markets, Intercontinental Exchange, Chicago, Illinois; Ms. Marnie Rosenberg, Global Head, Clearinghouse Risk and Strategy, JPMorgan Chase and Company, New York, New York; Mr. Stephen Merkel, Executive Vice President, General Counsel and Secretary, BGC Partners, Incorporated, New York, New York, on behalf of the Wholesale Markets Brokers' Association; Mr. Stephen John Berger, Director, Government and Regulatory Policy, Citadel, LLC, New York, New York, on behalf of the Managed Funds Association; Mr. Luke Zubrod, Director, Risk and Regulatory Advisory Services, Chatham Financial, Kenneth Square, Pennsylvania.

Mr. Duffy, please begin when you are ready.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Mr. DUFFY. Thank you, Mr. Chairman. Chairman Scott, and Ranking Member Scott, Members of the Subcommittee, I am Terry Duffy, the Executive Chairman and President of CME Group, and I thank you for the opportunity to testify today regarding the G20 clearing and trading commitments.

These commitments were meant to create a global regulatory framework; however, some G20 nations have not implemented core elements of the G20 reforms consistently. For example, regulatory requirements for clearinghouses have not been defined on a coordinated basis. This has the potential to create inconsistency, uncertainty, and disruption to the smooth functioning of global derivatives markets.

Fortunately, negotiations between the U.S. and the EU on equivalence were successfully resolved in February. That is when the European Commission originally granted the CFTC equivalent status. The European Securities Market Authority is now implementing that agreement. It is ensuring that the CME clearing is recognized as equivalent in advance of the June 21 date for European clearing mandate.

I want to applaud Chairman Massad and his European counterparts for working through their differences and reaching a positive outcome. However, the process took too long. This created considerable uncertainty for European participants wanting to clear products in the United States. We encourage global regulators to avoid this kind of potential market disruption in the future. They should implement long-term solutions. They should not force markets to go through a national equivalence and recognition process every few years. Otherwise, regulation will artificially influence liquidity, price discovery, and risk management. It will disadvantage individual markets in an increasingly competitive global marketplace.

Beyond equivalence, the global clearing mandates have also led to increased focus on clearinghouses' risk management. In 2012 and 2013, enhanced risk management standards were adopted for clearinghouses. More recently, there has been a focus on recovery and resolution. Central clearing increases transparency, reduces systemic risk, and strengthens the financial system. Clearing members and market participants bring risk to the clearinghouse through their trading activities. In contrast, a clearinghouse's core function is to manage that risk. We don't create the risks.

Clearinghouses are responsible for ensuring the overall safety and soundness of their markets. CME Clearing uses a number of tools to monitor and limit the risk it manages. These include its safeguards packages and waterfall structure. They provide a firewall against a potential systemic impact of a failing clearing member. These tools have proven themselves to be extremely effective in stressed markets and during the worse financial crisis in memory.

We have long supported first loss contributions to each of our financial safeguard packages. This further aligns our interests with those of market participants. We are committed to ensuring that the capital contributions from clearing members, as well as CME, will be sufficient to avoid the mutualization of losses in a default situation. As a result, when addressing a clearing member failure, CME Clearing has never had to access the default fund contribution of a failing clearing member, the mutualized capital of its clearing members, or the capital that CME has in its default fund.

Effective risk management must strike a balance between initial margins, clearinghouse contribution capital, and clearing member guarantee fund contributions. This ensures that all market participants have appropriate incentives to manage risk across the markets.

Before closing, I want to mention the leverage ratio rule adopted by the Basel Committee and the Federal Reserve. It is an example of a regulation that is at odds with the G20 commitments to clearing. The leverage ratio will make clearing more expensive and less accessible. Why? Because it fails to recognize how customer collateral, appropriately segregated, reduces exposures. The Basel Committee recently proposed changes to the rule, but they stopped short of endorsing a segregated collateral offset for client-cleared derivatives. Customer collateral is legally required to be segregated, reduces exposures, and cannot be used to increase a clearing member's leverage. Without such an offset, clearing costs will increase. Further, moving the clients of defaulted clearing members will be much more difficult.

I thank you for your time and attention this morning, and I look forward to answering any questions you may have of me.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

The G20 commitments were meant to create a global regulatory framework. However, some G20 nations have not implemented the core elements of the G20 regulatory reforms consistently. This lack of coordination has the potential to create inconsistency, uncertainty, and potential harm to the efficient functioning of U.S. and global derivatives markets.

Equivalency and Recognition

As one example of this inconsistency, regulatory requirements for clearinghouses have not been defined on a coordinated basis. Fortunately, the negotiations between the U.S. and EU on equivalence were successfully resolved in February, when the European Commission officially granted the CFTC "equivalent" status. The European Securities Markets Authority is now implementing that agreement by ensuring that CME Clearing is recognized as equivalent in advance of the June 21 start date for the European clearing mandate.

However, the process for U.S. clearinghouses obtaining equivalence and recognition in Europe has taken far too long. While we applaud Chairman Massad and his European counterparts for working through their differences and reaching a positive outcome, we encourage policymakers on both sides of the Atlantic to ensure that market participants do not have to deal with the uncertainty created by such long delays in reaching a cross-border agreement. This requires agreement among global regulators to implement long-term solutions for increasingly global markets and not force markets to go through national equivalence and recognition processes every few years.

If this is not the case, then regulation will artificially influence liquidity, price discovery and risk management, and competitively disadvantage individual markets in an increasingly competitive global marketplace.

Risk Management through Central Clearing

Congress has taken important steps toward strengthening the U.S. financial system post financial crisis. By way of example, a clearing mandate has been imposed for certain swaps—requiring that they be cleared through central clearinghouses like CME Clearing. These reforms increase transparency and reduce systemic risk by using the best practices of central clearing in the broader financial markets.

A clearinghouse's core function is risk management—not trading or other types of risk creation. Unlike clearing members and market participants, clearinghouses do not bring risk to the clearing system. Instead, clearinghouses are responsible for ensuring the overall safety and soundness of their markets.

Clearinghouses, like CME Clearing, utilize a number of tools, such as the financial safeguards package and waterfall structure, to monitor and limit the risks brought by its clearing members and customers and to limit the systemic impact of a failing clearing member. These tools have been tested in stressed markets and have demonstrated their effectiveness against the worst financial crises in memory. CME Clearing has never had to access a defaulting clearing member's default fund contribution, CME's own contributed capital, or the mutualized capital of its clearing members to address a clearing member default. At its core, the clearing mandate and other related financial reforms were driven by a decision by the G20 that the robust performance by clearinghouses during the financial crisis suggested that their market structure and risk management should be a template for the financial markets, going forward.

In response to the swaps clearing mandate, some have called for greater scrutiny of clearinghouse risk management, including the amount of capital that clearinghouses should be required to hold. We support best practices in risk management. It is critical, however, to recognize that the central clearing mandate was adopted due to clearinghouse resiliency during the financial crisis. Furthermore, the CFTC and other global regulators have significantly enhanced the risk management standards applied to clearinghouses beyond those which performed robustly during the financial crisis. The failure to recognize the increased resiliency of clearinghouses following these changes potentially risks distracting the regulatory focus away from less robust areas of the financial markets.

Unlike the participants in our markets, risk management is the core function of CME Clearing and we have strong motivation to ensure clearing member contributions and our own capital contributions will be sufficient to avoid the mutualization of losses in a default situation. Effective risk management must strike the appropriate balance between initial margins, clearinghouse contributed capital, and clearing member guaranty fund contributions to ensure that all market participants have appropriate incentives to manage risk across the market. CME Clearing has long advocated for clearinghouses to make meaningful, first-loss contributions to their financial safeguards packages. CME Clearing makes a sizeable contribution to each of its financial safeguards packages, which works to align our interests with those of our market participants.

In addition, CME Clearing regularly publishes public disclosures describing its risk management practices and measuring its available financial resources in compliance with local and international standards and best practices. This provides the market significant transparency into our risk management practices.

Some have also called for the introduction of a framework for addressing any losses that exceed the clearinghouse's financial resources. CME Group supports U.S. and international efforts to introduce robust recovery and resolution regimes for clearinghouses. However, we caution that no two clearinghouses are the same and the recovery and resolution framework should be tailored to the specific characteristics of each clearinghouse while ensuring that the tools prescribed are appropriately calibrated.

Clearinghouses should retain flexibility in designing their recovery tools to take into account dynamic market conditions, and the specific products and markets they serve. Clearinghouses must also have the flexibility and discretion to implement their recovery tools and maintain the ability to use all possible tools available to them prior to resolution.

Moreover, clearinghouses have the foremost expertise in managing the risks of the markets which they clear; therefore, we believe that a clearinghouse should only be put in resolution when the recovery process is exhausted. In addition to this expertise, the incentives of clearinghouses are aligned with overall market stability making them the appropriate pre-resolution decision-maker on the steps needed to recover their markets.

In some jurisdictions it is suggested that initial margin collateral provided by market participants should be used other than for its sole, intended purpose as collateral for cleared positions, but as a means to allocate losses or as a temporary source of liquidity. This is commonly referred to as "haircutting" initial margin collateral. CME Group strongly opposes the haircutting of initial margin collateral whether during recovery or resolution, both as unlawful in regards to clients under the Commodity Exchange Act and Dodd-Frank Act and as a matter of policy, due to its destabilizing impact on markets and its negative capital impacts.

Collateral haircutting directly impacts participants in pension funds and other end-users by appropriating their assets which are not designed to address mutualized risk and such appropriation is prohibited under U.S. law. Effectively, the haircutting of client collateral amounts to a taxpayer bailout due to the fact that the assets of participants in pension plans, the very people we are trying to protect, are put up as client collateral and would be at risk of appropriation if the haircutting of client collateral were permitted.

Haircutting of client collateral also creates a lack of incentive for market participants to actively participate in the default management process. CME Clearing is a strong supporter of sound risk management underpinned by the belief that market participants must be incentivized to manage the risks they create.

We encourage Congress to avoid inappropriate shifts in costs to end-users and reduction in clearing member incentives to actively manage their risk. The appropriate balance must be struck between initial margins, clearinghouse contributed capital, and clearing member guaranty fund contributions to ensure that all market participants have appropriate incentives to manage risk across the market.

Leverage Ratio

Finally, highlighting a regulatory inconsistency with regard to the G20 commitments, the supplemental leverage ratio rule adopted by the Basel Committee and the Federal Reserve is directly at odds with the G20 commitment to clearing.

Plainly speaking, the supplemental leverage ratio will make clearing more expensive and less accessible given its failure to recognize appropriately segregated client collateral in the centrally cleared derivatives markets. Customer collateral is required by law to be segregated, reduces exposures, and cannot be used to increase leverage. The Basel Committee has recently proposed changes to its leverage ratio framework; however it has stopped short of endorsing client collateral offsets for client cleared derivatives. Continued failure to do so will needlessly make more difficult a clearing firm's ability to accept a portfolio of fully margined clients of a defaulted clearing member.

The CHAIRMAN. All right, Mr. Edmonds.

STATEMENT OF CHRISTOPHER S. EDMONDS, SENIOR VICE PRESIDENT, FINANCIAL MARKETS, INTERCONTINENTAL EXCHANGE, INC., CHICAGO, IL

Mr. EDMONDS. Chairman Scott, Ranking Member Scott, I am Chris Edmonds, Senior Vice President, Financial Markets, for Intercontinental Exchange, or ICE. I appreciate the opportunity to appear before you today, and discuss the role of clearing and trade execution.

Since launching an electronic over-the-counter energy marketplace in 2000 in Atlanta, Georgia, ICE has expanded both in the U.S. and internationally. Over the past 16 years, we have acquired or founded derivative exchanges and clearinghouses in the U.S., Europe, Singapore, and Canada. ICE has a successful and innovative history clearing exchange-traded derivatives, and OTC derivatives such as energy and credit default swaps, or CDS. In 2008, ICE launched the first new clearinghouse in the UK in over a century; ICE Clear Europe, which clears energy, credit, and interest rate derivatives. We launched our CDS clearinghouse; ICE Clear Credit, in 2009, and it has since converted to a derivatives clearing organization following the implementation of Dodd-Frank.

Following the financial crisis in 2008, global financial ministers decided, to the extent possible, the OTC derivative market should be cleared. Global regulators recognized that a clearinghouse, by acting as a central counterparty to transactions, minimizes bilateral risk. As a result of increased clearing, market participants are realizing that moving uncleared positions and clearing creates both operational and capital efficiencies. For example, since 2009, ICE Clear Credit and ICE Clear Europe have cleared more than $78 trillion in CDS notional, but through compression and netting, currently maintain a combined open interest of approximately $1.5 trillion, significantly reducing the bilateral credit exposure among market participants, and reducing systemic risk.

Ironically, despite mandate-driven and natural growth in the volume of cleared contracts, the number of futures commission merchants, or FCMs, available to provide clearing services for end-users has dropped from 190 to 76 in recent years. The bulk of derivatives clearing is now concentrated in a few bank-owned FCMs.

These firms are constrained by the proposed requirement under Basel III that banks hold regulatory capital against clearing customer margin on their balance sheet, even though the customer margin is posted to a clearinghouse and held on a segregated basis.

ICE has joined a group of concerned market participants to encourage the Basel Committee to reconsider and refine aspects of this rule. We appreciate the several Members of this Subcommittee who have helped us raise the issue with banking regulators. The Basel Committee recently indicated it may rethink its position, and has requested further comment on the proposal. ICE and the broader derivatives industry are hopeful the Basel Committee will recognize segregated and the risk-reducing nature of customer funds that are restricted on bank balance sheets.

We are also pleased European and U.S. regulators reached an agreement on margin equivalence standards for CCPs in their respective jurisdictions. Further coordination between regulators is still required to ensure that these standards do not create opportunities for regulatory arbitrage or balkanize global markets. But this first step brings important regulatory certainty to clearing customers.

We are also hopeful the global regulators will reach agreement on equivalence between trade execution platforms within a reasonable timeframe. Over the past decade, ICE has invested heavily in our clearinghouse technology and risk management practices. ICE has kept pace with, and often preceded regulatory reforms, new global rules, and international standards that have been established with respect to risk controls, levels of protection, and proper functioning of clearinghouses. We have worked closely with regulators, clearing members, and end-users to implement clearing models that meet or exceed modern regulatory reforms and international standards. The result is an even more robust clearing model that includes many ICE-led initiatives such as the introduction of skin-in-the-game, or the contribution by clearinghouses of designated amounts of their own capital for the default waterfall.

ICE clearinghouses are subject to extensive regulatory oversight and strong corporate governance requirements, exercised largely through risk and advisory committees, and independent boards of directors. Risk committees include representatives from our clearing member firms, and in some cases, end clients. ICE clearinghouses regularly conduct margin back-testing, default fund stress testing, and liquidity stress testing, the results of which are reviewed by clearing members and regulators. The ICE clearinghouses also provide public disclosure of their margin back-testing, default fund stress testing, and liquidity stress testing as part of their compliance with the CPMI–IOSCO public quantitative disclosure standards. The rules, practices, and procedures of ICE's clearinghouses are fully transparent and publicly disclosed in a consistent manner. Any material change to ICE's clearing processes are subject to rigorous internal governance review, as well as applicable regulatory review and approval.

Thank you for the opportunity to share our views with you, and I would be happy to answer any questions you and the Members of the Subcommittee may have.

[The prepared statement of Mr. Edmonds follows:]

PREPARED STATEMENT OF CHRISTOPHER S. EDMONDS, SENIOR VICE PRESIDENT, FINANCIAL MARKETS, INTERCONTINENTAL EXCHANGE, INC., CHICAGO, IL

Introduction

Chairman Scott, Ranking Member Scott, I am Chris Edmonds, Senior Vice President, Financial Markets for Intercontinental Exchange, or ICE. I appreciate the opportunity to appear before you today to discuss the role of clearing and trade execution.

Background

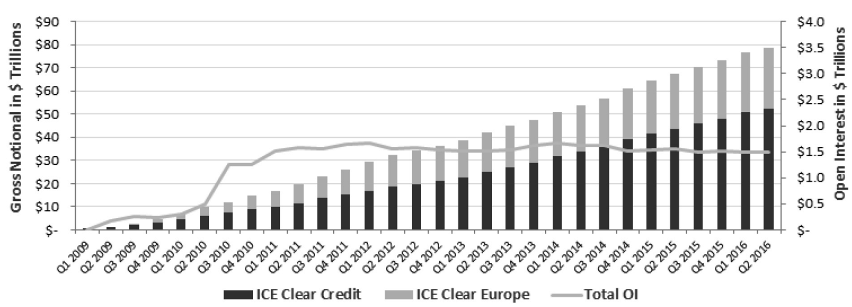
Since launching an electronic over-the-counter (OTC) energy marketplace in 2000 in Atlanta, Georgia, ICE has expanded both in the U.S. and internationally. Over the past sixteen years, we have acquired or founded derivatives exchanges and clearing houses in the U.S., Europe, Singapore and Canada. In 2013, ICE acquired the New York Stock Exchange, which added equity and equity options exchanges to our business. Through our global operations, ICE's exchanges and clearing houses are directly regulated by the U.S. Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Bank of England, the UK Financial Conduct Authority and the Monetary Authority of Singapore, among others.

ICE has a successful and innovative history clearing exchange traded derivatives and OTC derivatives such as energy and credit default swaps (CDS). ICE Clear Credit (ICC) began operating as a trust company in 2009 under the supervision of the Federal Reserve Board and the New York State Banking Department and converted to a derivatives clearing organization (DCO) following implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). In 2008, ICE launched ICE Clear Europe (ICEU), the first new clearing house in the UK in over a century. ICEU clears derivatives in several asset classes including energy, agriculture, interest rates and credit. In total, ICE owns and operates six clearing houses in North America, Europe and Asia.

Current Clearing Environment

Observers frequently point to a lack of cleared derivative contracts as a significant factor in the broad reach and complexity of the 2008 financial crisis. The disciplined and transparent risk management practices (including uniform collateral requirements and the daily marking-to-market of losses) associated with regulated cleared contracts serves to reduce systemic risk. Whereas, opaque bilateral OTC derivative transactions result in counterparty exposures that can become hard to unwind when the market experiences a period of widespread stress. A clearing house, by acting as a central counterparty (CCP) to transactions, minimizes bilateral risk by compressing derivative exposures. For example, since 2009, ICC and ICEU have cleared more than $78 trillion in CDS notional, but through compression currently maintain a combined open interest of $1.5 trillion, significantly reducing bilateral credit exposure among market participants and reducing systemic risk.

ICE Global Cleared Activity—Gross Notional *vs.* Open Interest



In response to the financial crisis, the G20 finance ministers decided that, to the extent possible, the OTC derivative market should be cleared. Congress followed suit with the DFA, which created a clearing requirement for liquid standardized derivatives. Today, certain U.S. and European CDS indices and certain interest rate swaps are mandated for clearing by the CFTC. The European Market Infrastructure Regulation (EMIR) created a similar clearing mandate for Europe. As a result of increased clearing, market participants are realizing that moving uncleared positions into clearing results in risk, operational and capital efficiencies.

Basel-Fueled Headwinds

Ironically, despite mandate-driven and natural growth in the volume of cleared contracts, the number of futures commission merchants (FCM) available to provide clearing services for end-users has dropped considerably in recent years. What had been an industry of 190 firms in 2004 was reduced to 76 firms by 2014, according to the Futures Industry Association. The bulk of derivatives clearing is now concentrated in a few bank owned global FCMs. These firms are constrained by the proposed Basel Committee on Banking Supervision's leverage ratio framework (Basel III). Basel III requires a bank to hold regulatory capital against clearing customer margin on its balance sheet notwithstanding that the customer margin is posted to a clearing house and held at the clearing house on a segregated basis. This Basel III capital requirement makes it more expensive for banks to offer clearing services, at the very time clearing capacity is shrinking and customer demand is increasing. Further, Basel III makes the transfer (or porting) of client positions much more difficult as banks must perform an assessment of their capital costs before accepting a client position transfer. This will complicate default resolution as banks will be less likely to accept client positions from a defaulting clearing member.

ICE has joined a group of concerned FCMs, end-users and other clearing house operators to encourage the Basel Committee to reconsider and refine aspects of the rule which is set to become final at the start of 2017. CFTC regulations already prohibit banks from using customer margin funds in any way other than to mitigate the risk reflected in customer positions. The Basel committee recently indicated it may rethink this position and has requested further comment on the proposal. ICE and the broader derivatives industry are hopeful the Basel Committee will recognize the segregated and risk reducing nature of customer funds that are restricted on bank balance sheets.

Regulatory Coordination

Earlier this year, European and U.S. regulators reached an important milestone on margin equivalence standards for CCPs in their respective jurisdictions. This determination encourages continued cross-border activity and will help prevent a fragmentation of liquidity for related contracts. Further coordination between the regulators is still required to ensure the standards do not create opportunities for regulatory arbitrage or balkanize global markets, but this first step brings important regulatory certainty to clearing customers. We are also hopeful that global regulators will reach agreement on equivalence between trade execution platforms within a reasonable timeframe.

Since the enactment of the DFA, ICE has also worked with the CFTC and the SEC to provide CDS market participants the benefits of capital efficiency that can come with the portfolio margining of risk off-setting positions.[1] The SEC developed a portfolio margining regime that requires each clearing member to create its own set of portfolio margining standards. Under these rules, there has been some progress in single name clearing but uncertainty remains. We look forward to working with the SEC to resolve the questions still limiting market participants' ability to use these critical risk management tools.

CCP Operation and Role in the Financial System

The central counterparty clearing model is effective and has been relied upon in futures markets for more than 100 years. The recent introduction of mandatory clearing obligations for certain swaps has increased awareness around clearing and the significant benefits it brings to the capital markets. Over the past 100 years, clearing house risk management practices have been repeatedly tested and have performed as designed in resolving clearing member defaults.

Over the past decade, ICE has invested heavily in our clearing house technology and risk management practices. ICE has kept pace with and often preceded regulatory reforms, new global rules, and international standards[2] that have been established with respect to risk controls, levels of protection and proper functioning of clearing houses. We have worked closely with regulators, clearing members and end-users to implement clearing models that meet or exceed modern regulatory reforms and international standards. The result is an even more robust clearing model that includes many ICE-led initiatives, such as the introduction of "skin-in-the-

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[1] CDS Index instruments are subject to CFTC regulation, while CDS single name instruments are subject to SEC regulation, therefore a coordinated effort was required to provide for portfolio margining for CDS.

[2] Committee on Payment and Settlement Systems, International Organization of Securities Commissioners (CPSS–IOSCO), *Principles of Financial Market Infrastructures* (April 2012). *http://www.bis.org/publ/cpss101a.pdf*.

game," the clearing house's contribution of a designated amount of its own capital to the default waterfall.

ICE clearing houses are subject to extensive regulatory oversight and strong corporate governance requirements, exercised largely through risk and advisory committees and independent boards of directors.[3] Risk committees include representatives from clearing member firms and, in some cases, end clients. ICE clearing houses regularly conduct margin back-testing, default fund stress testing, and liquidity stress testing, the results of which are reviewed by clearing members and regulators. In addition, the clearing houses' margin, guaranty fund and liquidity methodologies are independently validated on a routine basis.

The rules, practices and procedures of ICE's clearing houses are fully transparent and are publicly disclosed in a consistent manner, as set out within the CPMI–IOSCO Principles for Financial Market Infrastructures (PFMIs)[4] and various regulatory requirements. Any material changes to ICE's clearing processes are subject to rigorous internal governance as well as applicable regulatory review and approval.[5]

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and derivatives markets, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with regulatory bodies in the U.S. and abroad to ensure they have access to all relevant information available to ICE regarding trade execution and clearing activity on our markets. ICE continues to work closely with governments and regulators at home and abroad to address the evolving regulatory challenges presented by derivatives markets and will continue to work cooperatively for solutions that promote the best and safest marketplaces.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you and Members of the Subcommittee may have.

The CHAIRMAN. Thank you, Mr. Edmonds.

Ms. Rosenberg.

STATEMENT OF MARNIE J. ROSENBERG, GLOBAL HEAD, CLEARINGHOUSE RISK AND STRATEGY, JPMORGAN CHASE & CO., NEW YORK, NY

Ms. ROSENBERG. Thank you for holding this hearing, and extending JPMorgan Chase the opportunity to present our views on implementation of the G20 derivative reforms.

My name is Marnie Rosenberg, and I am the Global Head of Clearinghouse Risk within JPMorgan Chase's Independent Risk Management Function. Our firm is a leading provider of access to clearing across the globe.

The clearing mandate has benefitted the system overall by reducing risk and enhancing transparency. On the other hand, it has further concentrated risk in a small number of large global CCPs, and increased interconnectedness within the system.

Today, one of the critical public policy issues for regulators and policymakers is ensuring that CCP risk management and governance frameworks are appropriately aligned and effective for the systemic role that CCPs have assumed.

I lead a team that focuses on identifying, mitigating, and reducing our firm's CCP membership risks, and it is from this perspective that I raise three key questions for policymakers today. First, are CCPs sufficiently resilient to withstand the default of one or

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[3] For an overview of the risk governance at ICE clearing houses see: ICE Clear Europe—*www.theice.com/clear-europe/risk-management;* ICE Clear U.S.—*www.theice.com/clear-us/regulation;* ICE Clear Credit:—*www.theice.com/clear-credit/regulation*.

[4] *Supra,* nt. 2.

[5] For an overview of ICE central clearing operations and governance see: *https://www.theice.com/publicdocs/Central_Clearing_Reducing_Systemic_Risk.pdf*.

more clearing members, or a major loss arising from an operational failure or a cybersecurity attack? Second, do CCPs have adequate plans and resources to recover from such a loss to carry on offering critical services? And finally, if they can't recover, do they have credible resolution plans to continue to provide critical services, and ensure a CCP's failure does not cause broader market instability or require taxpayer assistant. Regulators, including the CFTC, have made significant progress in addressing these questions, but there remains widespread agreement that there should be more done.

The starting block for resilient CCPs is a strong, effective risk governance framework. Each CCP makes the decisions with respect to how they manage risk, including setting membership and eligible collateral requirements, establishing margin levels and overall financial safeguards, and determining the products that they offer for clearing. At the same time, clearing members bear the capital consequences of loss through the collective funds they provide to the CCP for loss mutualization. Therefore, risk governance rules should evolve to ensure that those that bear potential losses have a meaningful voice with how risk is managed.

This can be achieved by mandatory and meaningful consultation and inclusion of clearing members in the decision-making process, enhanced and consistent risk committee standards, and appropriate levels of a CCP's own resources at risk, often referred to as skin-in-the-game.

Robust and transparent stress testing is critical to ensuring a CCP has sufficient resources should a clearing member default. CCP-designed stress test frameworks should be subject to more prescriptive global standards, and the testing methodology should be more transparent to clearing members. This is critical for clearing members to identify and manage the risk inherent in using a specific CCP. Specifically, regulatory-driven stress tests would provide oversight and inform supervisory requirements by evaluating the adequacy of the CCP's financial safeguards. Results of these tests should be disclosed. We look forward to U.S. regulatory support on this front as global standards are developed over the next year.

While resiliency is important, it is also crucial to ensure collectively that CCPs can recover from a threat to their viability in order for them to continue to provide core services to the market and avoid systemic contagion. But a CCP's ability to allocate losses to clearing members through recovery tools, such as cash calls on members, must be very limited and subject to predetermined and predictable limits, otherwise, they can be pro-cyclical and have a destabilizing effect on the broader market. Moreover, bank regulators today expect and demand it.

Last, well-defined plans and pre-established resources to resolve systemically important CCPs in the case of an event are still needed. If a CCP is no longer a viable entity, it must be resolved in a manner that is not disruptive to the marketplace, and without public support. An effective resolution plan does not result in wind-down or liquidation, it means having tools and resources to replenish the default fund and regulatory capital, and reopen for business with a recapitalized CCP that can continue to provide these critical services to the market.

Thank you, and I look forward to taking questions.

[The prepared statement of Ms. Rosenberg follows:]

PREPARED STATEMENT OF MARNIE J. ROSENBERG, GLOBAL HEAD, CLEARINGHOUSE RISK AND STRATEGY, JPMORGAN CHASE & CO., NEW YORK, NY

Introduction

Chairman Scott, Ranking Member Scott, and Members of the Subcommittee, thank you for holding this hearing and for extending JPMorgan Chase the opportunity to present our views. My name is Marnie Rosenberg, and I am the Global Head of Clearinghouse Risk and Strategy within JPMorgan Chase's independent Risk Management Function.

We appreciate the Committee's leadership in holding this series of hearings to review implementation of the derivatives reforms agreed by the Group of Twenty (G20) in 2009.[1] It is and will continue to be important to ensure the objectives of increased transparency and a reduction in systemic risk are being met, while also monitoring the impact on the derivatives markets and the ability for businesses to access those markets to manage risk.

As this Committee knows well, American companies use futures and swaps to manage a wide variety of risks they encounter in their day-to-day business, such as interest rate risk when companies borrow money, currency risk when they sell their goods overseas or commodity risk posed by fluctuations in prices of raw materials used in production.

JPMorgan works with companies from all industry sectors who seek to hedge their risks in the swaps markets, which allows them to do so in a flexible and customized manner that is not possible in the exchange-traded markets. We serve end-users by providing liquidity, financing and customized risk management solutions across markets, including energy, metals and agricultural markets.

In addition, JPMorgan is a leading provider of access to clearing across the globe, with fifty-four memberships at forty-two clearing houses, or "CCPs" that offer futures and/or swaps clearing. In addition to its clearing memberships, JPMorgan provides services directly to CCPs globally, acting as a liquidity provider, cash manager, investment advisor, settlement bank and custodian.

I lead a team that focuses on understanding current and proposed CCP structures and identifying, mitigating and reducing membership risk and exposures to enhance how JPMorgan measures and manages our exposure to CCPs. We apply this experience and expertise to develop policy recommendations on CCP risk issues and to proactively engage in policy discussions affecting CCPs to best ensure a safe and sound financial system.

Today, I will focus on the importance of robust risk management frameworks at CCPs to the safety and soundness of the financial system.

Overview of State of Reform

Following the financial crisis, the leaders of the G20 nations agreed to a series of measures to increase the transparency of the over-the-counter (OTC) derivatives market and to reduce systemic risk. The reforms agreed to by the G20 included clearing of standardized OTC derivatives through CCPs, trading of standardized OTC derivatives on electronic platforms where appropriate, higher capital and minimum margin requirements on non-centrally cleared contracts, and requiring that all OTC derivatives transactions be reported to trade repositories.

Global initiatives have been underway to implement these changes for some time and they are in various states of legislation, regulation, and implementation. Many of these reforms have brought significant progress in a number of key areas, including: mandatory registration and regulation of swap dealers; mandatory clearing of standardized contracts between financial firms; greater pre- and post-trade transparency through public reporting requirements; and execution of certain standardized contracts on swap execution facilities (SEFs).

The Commodity Futures Trading Commission (CFTC) has written and adopted the bulk of regulations required to implement swaps market reforms under Title VII of the Dodd-Frank Act. These and other reforms, taken together, have reduced risk in the system and have facilitated greater transparency for regulators and market participants. They have also fundamentally altered the market structure of swaps:

[1] *http://www.g20.utoronto.ca/2009/2009communique0925.html.*

how and where these instruments are traded, the economics of transactions, the nature of products available to American companies and the liquidity and efficiency of these markets. And as I will discuss later in my testimony, mandatory clearing, in particular, has intensified the importance among regulators and market participants for CCP risk management standards across all clearinghouses, not just those that clear derivatives. This development is a positive outcome for overall market stability but our work is not yet complete. CCPs have now become deeply interconnected and core to our derivatives markets but we have yet to fully evolve their risk management and governance models to reflect this increasingly critical role.

This change in market structure is demonstrated by the fact that, for the interest rate swap markets as of the first quarter of 2016, 82.5% of the average daily notional value is now centrally cleared, and nearly ½ of the average daily trading activity is executed on a swap execution facility.[2] In contrast, in 2013, only 57.7% of the average daily notional value of interest rate swaps market was centrally cleared.

Now that the rules are largely in place and cleared volumes have increased, it is important for the CFTC and other policymakers to: (1) consider the implications of the changes to the derivatives markets, such as the growing importance of central counterparties to financial stability, and fragmentation in swaps markets; (2) review how emerging risks might best be managed and mitigated; and (3) determine whether adjustments to the rules or additional guidance may be appropriate to ensure the markets continue to meet the needs of all market participants.

The following observations and recommendations should be considered as the Committee and the CFTC continue their ongoing work in this area:

- Mandatory clearing requirements can reduce risk in the derivatives markets. As the volume of centrally-cleared contracts has increased, however, so has the importance of CCPs as sources of systemic risk. Expectations are that CCPs will only continue to grow in size, importance and inter-connectedness.
- Inter-connectedness among systemically-important CCPs and clearing members has increased across jurisdictions. Global CCPs share a common set of large members, raising the likelihood that a default at one CCP will have a cascading effect across the globe. These connections must be mapped and well-understood, and broader industry preparedness is needed to ensure that member default can be contained.
- It is critical for policymakers, regulators and market participants to review the existing CCP risk management, governance and oversight models to ensure they are commensurate with the systemic risk they now pose. Stakeholders need to ensure that sufficient safeguards are in place to promote the resilience of CCPs, and that there are robust plans in place to manage extreme stresses to the financial strength of a CCP without the use of public money. Similarly, operational resiliency is of paramount importance, requiring strong operational risk and cybersecurity risk management. Specifically:
    - ***CCPs should be subject to enhanced resiliency standards.***
        - Effective risk governance is the fundamental building block for resilient CCPs. CCPs should be subject to global minimum governance standards and "skin in the game" requirements to promote effective alignment of interests and proper risk management.
        - CCPs should be transparent to market participants regarding their risk methodologies used to size their aggregate financial safeguards. Higher minimum standards are needed for CCP stress testing frameworks, and standard regulatory-driven, disclosed stress test frameworks should be implemented to provide confidence in the adequacy of loss absorbing resources held by CCPs.
        - Regulators, CCPs and clearing members globally should work together to implement and test default management protocols in a coordinated manner across CCPs.
    - ***Robust recovery tools should avoid pro-cyclicality and market destabilization.***
        - A CCP's ability to make cash calls on its members as part of recovery must be very limited and subject to a consistent global standard.
        - Use of novel recovery tools, such as contract tear-up or gains haircutting, have the potential to impose unpredictable losses on participants and should be limited in CCP recovery and overseen by an impartial authority.

[2] *http://www2.isda.org/functional-areas/research/research-notes/.*

  - ***Resolution plans should ensure continuity of clearing services while minimizing risks to financial stability and to taxpayers.***

- At the same time, new capital requirements under the leverage ratio do not adequately reflect exposure from cleared derivatives and have made it difficult for many clearing member banks to offer clearing services. End-users are beginning to feel the impact of this constraint through reduced access to clearing and increased costs.[3] This creates a distinct tension between the safety and soundness objectives of prudential regulators and those of market regulators, like the CFTC, responsible for implementing the G20's clearing mandate to reduce risk in the derivatives markets.
- The recent agreement between the CFTC and the European Commission with regard to recognition of U.S.-based CCPs by European authorities was a critical development in ensuring a global market for swaps. It also underscores the importance of cross-border coordination on an ongoing basis among regulators around the world, particularly as U.S. and EU authorities begin discussions related to trading venue equivalence.
- Finally, the use of SEFs is an important mechanism for enhancing transparency in the swaps markets. Minor adjustments to the CFTC's rules setting out the process for determining swaps mandated to be traded on a SEF and the modes of execution permitted would help to mitigate unnecessary reductions in liquidity that have been widely observed since the SEF rules went into effect.

The New Clearing Ecosystem

I. CCP Resiliency, Recovery and Resolution

One of the key components of the G20 agenda on derivatives reforms was mandating the use of CCPsfor the clearing of all standardized OTC derivatives contracts. A CCP interposes itself betweencounterparties to a derivatives transaction, whereby the CCP becomes the buyer to every seller and theseller to every buyer. The use of CCPs creates numerous benefits for market participants and thefinancial system by providing for centralized risk management and processing as well as risk reductionthrough collateralization of trades and multilateral netting.

The increased use of CCPs has led to concentration of credit, liquidity, operational and legal risk arising from OTC derivatives in a small number of the large global CCPs. These risks are now centrally managed by CCPs themselves and market participants must rely upon CCPs to maintain appropriate membership criteria and risk management standards, and conduct ongoing, adequate member due diligence. This dependency upon CCPs to maintain strong risk management standards existed prior to the introduction of mandatory swaps clearing but has now become more pressing as mandatory clearing in multiple jurisdictions has led to further concentration of risk while, at the same time, market participants no longer have the option to execute and clear bilaterally if they become concerned with a CCP's risk management protocols. While mandatory clearing has been in effect in the U.S. for nearly 3 years, market participants will need to begin complying with the European Union's (EU) clearing requirement for OTC derivatives products later this month.[4] Other jurisdictions have also moved forward with mandating the use of CCPs for certain standardized OTC derivatives. Further, as rules imposing margin requirements on swaps that are not cleared are implemented beginning in September 2016, an even greater use of CCPs is anticipated from market participants seeking to voluntarily clear additional products to benefit from margin efficiencies and multilateral netting that can be gained through clearing.

Due to JPMorgan's role as a significant clearer in global derivatives markets, it is imperative that we understand our own exposure and risks to CCPs, and evaluate how and whether the current regulatory and legal structures for CCPs are sufficiently suited to their growing importance to the financial system. This is why JPMorgan published a paper in 2014 called "*What is the Resolution Plan*" for CCPs.[5]

In the current derivatives clearing "ecosystem", policymakers and market participants need to address some key questions:

- Are CCPs sufficiently resilient that they can withstand a clearing member(s) default or major loss through sufficiently strong first line of defense measures: are membership criteria robust, is eligible collateral limited to the highest qual-

[3] *http://www.sifma.org/issues/item.aspx?id=8589958563; http://www.commoditymkts.org/wpcontent/uploads/2015/11/CMC-MFA-Leverage-Ratio-Letter-End-User-Impact-Final.pdf.*

[4] *https://www.esma.europa.eu/regulation/post-trading/otc-derivatives-and-clearing-obligation.*

[5] *https://www.jpmorganchase.com/corporate/About-JPMC/document/resolution-plan-ccps.pdf.*

ity liquid assets and are products that are cleared sufficiently liquid, standard, and suitable for clearing?

- Do CCPs have adequate plans to recover from such a loss and carry on offering critical services?
- If CCPs can't recover, do they have adequate plans to continue to provide critical services and ensure the failure of a CCP does not cause wider market instability or require taxpayer assistance?

In response, we have come a long way, but more work is needed.

Currently, CCPs are expected to meet higher regulatory and risk management standards, including internationally agreed to standards published by the Committee on Payments and Market Infrastructure (CPMI) and the International Organization of Securities Commissions (CPMI–IOSCO) in 2012, referred to as the *Principles for Financial Market Infrastructures* (PFMIs)[6] as implemented in the U.S. by CFTC rulemakings under authorities in Title VII and Title VIII of the Dodd-Frank Act. Nevertheless, regulators around the world have acknowledged that more work is needed, and CCPs have become a high priority on the agenda for global financial regulatory standard-setting bodies, including the Financial Stability Board and CPMI–IOSCO and we expect this focus to continue. These bodies are largely comprised of regulators, central bankers and in some cases, finance ministries from the U.S. and around the world.

CCPs Should be Subject to Enhanced Resiliency Standards

A resilient CCP should have the ability to withstand severe stress events such as clearing member defaults, and this can be achieved by having strong membership requirements to ensure the soundness of its clearing members while also ensuring fair and open access, robust risk management standards and adequate capital and liquidity resources. A resilient CCP must also be able to have sufficient controls and protections in place to withstand significant losses stemming from non-default events, such as fraud or a cybersecurity attack.

There are four key recommendations on how to improve CCP resiliency and strengthen the clearing ecosystem:

(1) **Effective risk governance is the cornerstone of resilient CCPs. CCPs should be subject to global minimum risk governance standards and "skin in the game" requirements to promote effective alignment of interests and to incentivize strong risk management.**

Many CCPs have migrated from being utilities owned by members to private for-profit institutions. This shift introduces an inherent tension and potential conflict of interest between a CCP's role as a market utility that can mutualize potential losses among its members and its commercial objectives to increase revenues and earnings/dividends for its shareholders and market share. The fact that its members bear the losses also introduces an element of moral hazard.

CCPs make key decisions impacting the risk profile of the CCP and its membership, with respect to the products that can be cleared, the members who participate in the CCP, the framework used to mitigate the risk brought in by participants, the type of collateral that can be posted and the aggregate amount of safeguards to maintain. However, it is clearing members of the CCPs that bear the capital consequences of any losses, through the collective funds (the "default fund") they provide to the CCP for loss mutualization. Therefore, CCP risk governance structures should evolve to ensure that those that bear potential losses and market risk as part of default management have a meaningful voice with regard to how risk is brought into the CCPs. Governance needs to be commensurate with the changed role of CCPs and the new responsibilities that CCPs have within the financial system. This can be achieved by mandatory, meaningful consultation and inclusion in the decision making process for clearing members, availability of appropriate, funded amounts of a CCP's own resources ("skin in the game") and increased capital available at the end of the waterfall.

Governance. Members themselves must have more of a say in material risk decisions that are made by the CCP as it impacts their own capital contributions through the default fund. Current U.S. regulation does not require CCPs to incorporate and demonstrate input from clearing members or CCP risk committees early in the process with respect to key risk management decisions impacting clearing members' liability. CCPs globally should therefore be required to obtain input from their clearing members and the CCP's relevant risk committees on all material risk matters such as products that can be cleared, changes to loss mutualization rules,

[6] *http://www.bis.org/cpmi/publ/d101a.pdf.*

and post-default risk management decisions. CCPs should be required to maintain records and report any conflicts between CCP decision, risk committee opinion and clearing member views. In addition, consistent global standards are needed with respect to a CCP's risk committees. Risk committees should be required to have clearly-defined mandates, diverse memberships, and minimum member qualifications. The risk committee representatives should provide an independent, expert opinion on a CCP's risk management strategy and the impact of a CCP's actions on CCP and member stability, market integrity and clients.[7] If the views of a CCP's risk committee are not incorporated by the CCP in making key risk management decisions, the CCP should be required to document and disclose to regulators how the risk committee's views have been addressed.

"Skin-in-the-game". CCPs should be subject to a meaningful risk-based minimum contribution to the guarantee fund ahead of non-defaulting members called "skin in the game" (SITG). While many CCPs currently contribute such capital to their overall financial safeguards, the current level of CCP contributions, at generally less than 5% of the member default fund, are not sufficient. The CFTC currently does not require CCPs to have minimum SITG capital contributions. CPMI–IOSCO is expected to issue a market consultation this year to set global standards, which is a welcome and positive development. Having a risk-based, minimum level of SITG would appropriately align incentives amongst the CCP and its members and ensure proper risk management and governance. Aligning and scaling CCP contributions with those of the largest clearing members will also help to ensure that membership requirements remain strong and will limit the possibility that any single member becomes too large as a proportion of total risk.

CCP Capital. The current minimum CFTC and global capital requirements for CCPs should be reviewed. Currently, CCPs are required to cover at least 6 months of operating expenses under CPMI–IOSCO standards and twelve months under CFTC requirements. This is primarily meant to cover business and operating risk and any losses that arise by a non-member default event such as cyber risk, technology failure, or fraud. However, CCP capital should be available for *both* default and non-default losses. Members should not be responsible for non-default losses. This should be the responsibility of the CCP's shareholders. The size and impact of such events are untested and the current capital levels may be insufficient to cover losses. Sufficient standards are needed to address operational risk, and in particular, cyber-risk through investments in expertise and ensuring infrastructures to handle these risks are adequate. This is front and center on the international regulatory agenda and the work done by CPMI–IOSCO and the CFTC to address these risks through consultations on cybersecurity and operational controls is another welcome and positive development.

(2) **CCPs should be more transparent to market participants regarding risk methodologies used to size their aggregate financial resources to cover the largest single (or two) member defaults.**[8]

Clearing members and their clients must have access to and transparency around the methodologies used by CCPs to develop financial safeguards in order to identify and manage the risks inherent in using a specific CCP. For example, transparency regarding stress scenarios used by a CCP to determine the size of financial safeguards is necessary to provide clarity to participants on whether the CCP has sufficient resources to absorb default losses.

While the industry has made significant progress on CCP transparency over the last 3 years, more must be done. Regulators around the world continue to voice support for market participants' calls for transparency and now require public disclosures through the CPMI–IOSCO quantitative disclosures standard that was published in February 2015.[9] Current, standard disclosures are useful to participants on many levels but these disclosures alone are not sufficient as they do not permit CCP users to replicate margin models and do not provide details of the stress scenarios that a CCP has determined it will be able to withstand. The more market participants can adequately measure and manage their credit risks to CCPs, the more confidence the system will have that CCPs have sufficient resources to withstand a crisis.

(3) **More prescriptive, minimum global standards are needed to govern CCP stress testing along with the establishment of standard regu-**

[7] *https://www.theclearinghouse.org/issues/articles/2015/09/20150918-tch-comments-to-cpmi-iosco-on-ccp-riskgovernance.*
[8] *http://www.bis.org/cpmi/publ/d101a.pdf.*
[9] *http://www.bis.org/cpmi/publ/d125.pdf.*

latory-driven, disclosed stress test frameworks to provide confidence in the adequacy of aggregate financial safeguards held by CCPs.

Adequate stress testing of CCP members and their client portfolios is key to evaluating whether a CCP has sufficient resources should a clearing member(s) default. To ensure this, a CCP's financial safeguards should be sized based on CCP-designed stress test frameworks that are subject to minimum and more prescriptive standards that are transparent to clearing members and other market participants. In addition, there should be regulatory-driven stress tests that then provide oversight and inform supervisory requirements by evaluating the adequacy of the CCP's financial safeguards with appropriate consequences should a CCP fail the test.

There has been significant progress towards enhanced standards for stress testing,[10] and CPMI–IOSCO is expected to issue a consultation with additional guidance for CCPs in the third quarter of 2016. In addition, European regulators recently conducted stress tests of CCPs in Europe, and it is important that such a framework is extended to CCPs globally.

(4) **Regulators, CCPs and clearing members globally should work together to develop, implement and test standard default management protocols in a coordinated manner across CCPs.**

It is important for policymakers to consider that a large clearing member default could occur simultaneously at multiple CCPs and that CCPs are highly dependent upon non-defaulting members to help manage the default, participate in the default management process and absorb the defaulter's portfolio with its associated market risks. A CCP's dependency upon the resources and expertise of its broader membership to achieve a successful default management outcome cannot be underestimated, and market and prudential regulators, CCPs and all of their participants have a vested interest in making sure this happens. Currently, while each CCP tests its default management protocols with its members through default management fire drills, these drills are done in isolation and not in collaboration with other CCPs. An extreme market stress event that occurs across CCPs in multiple jurisdictions could severely constrain the ability of non defaulting members to respond effectively. In order to ensure market preparedness for such an event, a coordinated approach to drills under the joint oversight of relevant regulators, and a push for more standardized default management protocols among global CCPs is necessary. As an example, a recent joint default management exercise run by UK and German authorities coordinated across two CCPs, LCH and Eurex, was an important step in the right direction. However, more is needed, including involvement of U.S. CCPs and authorities in future work. This will be a topic at an upcoming Market Risk Advisory Committee meeting at the CFTC, for example, which is a very welcome development.

Robust Recovery Tools Should Avoid Pro-Cyclicality and Market Destabilization

Focusing on CCP resilience is a necessary first step, but it is not sufficient on its own. To the extent that resiliency measures are not sufficient, CCPs are required to have robust recovery plans that ensure continuity. "Recovery" refers to the ability of a CCP to recover from a threat to its viability so that it can continue providing its critical services without entering into resolution or insolvency. While efforts are appropriately focused on reducing the likelihood of any CCP entering recovery, it is important that CCPs are prepared through comprehensive and effective recovery plans that are also transparent, measurable and acceptable to members who bear the majority of the risk.

In 2013, the CFTC adopted rules requiring systemically important CCPs to comply with international standards for CCPs, including a requirement to maintain viable recovery plans. Since that time, U.S. CCPs have been revising their end of waterfall rules to put in place robust processes, agreements and defined tools to support recovery.

Clearly defined, transparent, and robust *ex ante* CCP recovery plans that do not lead to destabilizing and pro-cyclical effects are essential. Specifically:

(1) **A CCP's ability to make cash calls on its members as part of recovery must be very limited and be subject to a consistent global standard.**

Currently, CPMI–IOSCO and the CFTC do not prescribe rules with respect to the number of cash calls that a CCP can impose upon its members. This has led to CCPs implementing varied rules which make it difficult for members to measure

[10] In July of 2015, ISDA sent a letter to CPMI–IOSCO setting out the industry's principles for CCP stress testing: *www.isda.org*.

and manage their own exposures. The interconnectedness among CCPs suggests that there could be multiple, simultaneous cash calls on the same clearing members. In the absence of limits, the cash calls may not be reliable, particularly in a stressed market, and could lead to liquidity and funding issues that would be vectors for further financial instability.

(2) **Use of novel recovery tools, such as contract tear-up or gains haircutting, have the potential to impose unpredictable losses on participants and should be limited in CCP recovery and overseen by an impartial authority.**

Gains haircutting is a tool for allocating losses in recovery that is being implemented by CCPs to satisfy their regulatory requirement to ensure comprehensive loss allocation. This tool allows CCPs to reduce any payments it owes to participants. Most importantly, it could lead to disproportionate distribution of losses to certain market participants, which could in turn incentivize such participants to take actions with respect to their positions that are destabilizing or otherwise inhibit the CCP's recovery.

Similarly, CCPs have proposed partial tear-up as a way to restore the CCP to a matched book should default management protocols fail to successfully liquidate the defaulter's portfolio. The CCP would tear-up positions of the defaulter and those non-defaulting participants that hold equal and offsetting positions at a price determined by the CCP. Because this tool would be used during a period of illiquidity, establishing a fair market price would be quite challenging and subjective on the part of the CCP.

A CCP's decision to use recovery tools like gains haircutting and partial tear-up should be overseen by an impartial authority, and require compensation to be paid by the CCP to participants who suffer losses. While the CPMI–IOSCO recovery report already contemplates compensation in particular, U.S. regulators should consider issuing guidance in this regard.

Resolution plans should ensure continuity of clearing services while minimizing risks to financial stability and to taxpayers.

If a CCP is no longer a viable entity for the performance of its critical functions, it should be resolved in a manner that is not disruptive to the marketplace, is not reliant on taxpayer assistance and allows for operational continuity of a newly capitalized entity under new ownership that can continue its critical functions.

The trigger point for resolution should be the point at which the exercise of recovery tools becomes too destabilizing for the market, threatens the sustainability of the CCP or when the CCP is otherwise near or in default. As opposed to recovery, a resolution would be managed by resolution authorities, such as the Federal Deposit Insurance Corporation (FDIC) in the U.S., and could lead to a change in ownership, a write-down of the CCP's equity and the replacement of the CCP's management.

Resolution authorities should develop public sector playbooks or action plans that facilitate continuity, are made available to participants on a confidential basis, address default and non-default losses and provide resolution authorities with appropriate flexibility to determine the entity to be put in resolution. In addition, CCP resolution plans should not interfere with the resolution plans of clearing members, or lead to contagion in other services or segments cleared by the CCP, and should minimize risks to market participants and the broader financial system. CCP resolution plans should also specify *ex-ante* resources for the recapitalization of the CCP with respect to both regulatory capital as well as default fund replenishment so that it can re-open for business and provide its critical services without taxpayer assistance.[11]

The resolution regime in the U.S. currently provides for CCPs to be resolved under Title II of Dodd-Frank, but it does not provide any further framework regarding the tools or resources that can be used to resolve CCPs. Further work needs to be done to confirm how a Title II resolution would be effectuated for the different ownership and capital structures of systemically-important CCPs.

Recognizing the need for greater prescription, the Financial Stability Board (FSB) is expected to consult later this year on further guidance on strategies and tools for CCP resolution, such as the resources that can be used, the structure to be adopted,

[11] The Clearing House and the International Swaps and Derivatives Association recommended in a recent industry paper that authorities should consider the "implementation by CCPs of arrangements to maintain replenishment resources that could be used to backstop the timely replenishment of the default fund on an interim basis (or any failure of a clearing member to perform its replenishment obligation)."

the legal framework to be applied, the authority responsible for resolution, and cross-border coordination issues in the context of a CCP resolution. U.S. regulators should issue new guidance in line with the FSB's recommendations, which would also support future equivalence discussions with various jurisdictions.

II. Capital Constraints are Reducing Access to Clearing for Market Participants

This Committee and the CFTC should be complimented for their leadership in examining the impact of the leverage ratio on the cost of clearing for end-users and other market participants. Clearing members are fully responsible to the CCP for the performance of the transactions they clear for their clients, and clearing members collect margin from those clients to offset their exposure to them. The margin collected by clearing members is segregated from our own funds as required by the Commodity Exchange Act and firms cannot leverage it.

The Basel Committee's leverage ratio proposal, however, does not recognize the exposure reducing effect of the margin collected, and does not allow firms to offset off-balance exposure arising from client transactions against the value of the margin maintained in segregation.

This approach creates a disincentive for many clearing member banks to offer clearing services due to the higher capital requirements, a result at odds with the G20 mandate to move more derivatives into central clearing. End-users are already seeing the effects of this approach, as there are fewer banks offering clearing services and end-users are already seeing the price of clearing increase.[12]

In its recent consultation regarding revisions to the leverage ratio, the Basel Committee did seek input from stakeholders regarding the impact of the failure to recognize initial margin as an offset, on the cost of clearing. An industry-wide response is being prepared to demonstrate the reduction in access to clearing for end-users, and we appreciate and look forward to the continued support of this Committee.

III. Mutual Recognition of CCPs is Key to a Global Derivatives Market

The G20 leaders' 2009 agreement on derivative reform included a commitment to undertake reform without causing market fragmentation. This is an important goal given the global nature of the derivatives market. In practice, despite common objectives, technical and legal differences in national rule implementation have led to concerns around regulatory conflicts, inconsistencies, arbitrage, gaps and duplicative requirements which could undermine this goal. Subsequent G20 communiqués have emphasized the need for regulators to address these issues.

The lengthy negotiation between U.S. and EU authorities on EU recognition of U.S.-based CCPs regulated by the CFTC illustrates the challenges faced. Policymakers had struggled to reach agreement due in part to differences in the applicable initial margin regimes in each jurisdiction. Following negotiations lasting over 2 years, in February 2016, the CFTC and European Commission announced a "Common Approach" regarding requirements for CCPs.[13] This was a welcome development, alleviating prolonged uncertainty which had been detrimental for market participants in the U.S. and EU, as well as in other jurisdictions seeking recognition in these markets.

The agreement between EU and U.S. authorities is critical to mitigating unnecessary reductions in cross-border trading and market liquidity by ensuring market participants across both continents have continued access to CCPs in each other's markets, and to prevent European banks from facing punitive capital requirements for exposures to U.S.-based CCPs.

The process will help to instruct and streamline future equivalence and substituted compliance determinations between U.S., EU and other authorities, particularly with respect to equivalence for trading venues and substituted compliance for clearing, trade execution and margin requirements, to ensure that derivative markets remain global, liquid and resilient. It is important that regulators focus on thematic and outcomes-based determinations, rather than pursuing a granular element-by-element approach. It is also important to recognize that markets are global and that the global economy benefits most if capital is able to freely flow across those markets.

Trade Execution and the Implementation of the SEF Mandate

I. Evolution in Swaps Execution

Title VII of the Dodd-Frank Act established a comprehensive regulatory framework for swap trading platforms with the intent of furthering two policy objectives:

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[12] *http://www.sifma.org/issues/item.aspx?id=8589958563; http://www.commoditymkts.org/wpcontent/uploads/2015/11/CMC-MFA-Leverage-Ratio-Letter-End-User-Impact-Final.pdf*

[13] *http://www.cftc.gov/PressRoom/PressReleases/cftc_euapproach021016.*

(1) increasing pre-trade transparency to market participants before the point of execution; and (2) promoting trading on regulated exchanges. To achieve these objectives, Title VII created new types of trading facilities for swap execution known as swap execution facilities ("SEFs"), established core principles for the orderly and efficient operation of SEFs and introduced a requirement that certain swaps subject to the trade execution requirement in Section 2(h)(8) of the Commodity Exchange Act ("CEA") be traded on or pursuant to the rules of a SEF or traditional exchanges (designated contract market ("DCM")).

In June 2013, the CFTC adopted final rules that, among other things, defined which trading facilities and platforms must register as SEFs, established prescriptive requirements for SEFs to operate in accordance with SEF core principles and, although not expressly required by Dodd-Frank, created a process for determining which swaps are subject to the CFTC's trading mandate ("Mandated Swaps"). That process is commonly known as the "made available to trade" or "MAT" process. The CFTC's final rules' further required that all multiple-to-multiple trading platforms that list swaps to register as SEFs, even if those platforms do not offer Mandated Swaps for trading.

Since the CFTC's final trade execution rules came into force in October 2013 and the introduction of SEFs the CFTC's reforms have brought greater transparency, better price information and significant enhancements to market integrity. Notwithstanding these achievements, research shows that global derivatives markets have fragmented along geographic lines.[14]

These rules require all electronic trading platforms that provide access to U.S. investors for swap execution to register with the CFTC as SEFs. Under the CFTC's final rules, Mandated Swaps must be executed on a SEF or DCM through an electronic order book or a request-for-quote system that operates in conjunction with an order book.[15] This trading requirement has fundamentally changed the trading protocols and widely-accepted trading practices that were in place for market participants before the adoption of the CFTC's final rules.

In February 2014, the first series of swaps became subject to the CFTC's trading mandate. As of that date, all U.S. persons (and non-U.S. persons trading with U.S. persons) had to trade Mandated Swaps on registered SEFs or DCMs and all SEFs and DCMs that listed Mandated Swaps were required to do so in accordance with the CFTC's final rules.

II. Market Impact of the CFTC's Final Rules

In effect, since the CFTC's trade execution requirements are restrictive and burdensome, non-U.S. market participants are choosing not to trade on SEFs. In addition, since the CFTC has not establish a process of recognizing non-U.S. trading venues that are subject to comparable regulatory oversight, U.S. participants have limited access to these non-U.S. based platforms and arguably non-U.S. liquidity pools.

These unintended consequences are most evident in the global interest rate swap markets which have inhibited market participants from getting better pricing on derivatives resulting from varying levels of market fragmentation. This pattern is most persistent in euro-denominated interest rate swaps (IRS), where the vast majority of trading activity occurs between European dealers. ISDA research finds that 91.2% of cleared euro IRS activity in the European interdealer market was transacted between European counterparties in December 2015. In September 2013, immediately prior to the introduction of the SEF rules, this figure stood at 70.7%.[16]

Although concerns over best pricing have been discussed for almost 3 years, there are no signs currently that this trend is reversing. CFTC Chairman Massad's recent statements that suggest the CFTC is planning to make some adjustments to their final trade execution rules are welcome and important for promoting market efficiency. In this regard, market participants have put forth recommendations to improve pricing and restore liquidity in the derivatives markets, while still achieving the objectives of the reforms.

III. Market Participants Want Additional Choice in Execution and Greater Flexibility in SEF Rules

As noted above, the CFTC's final rules require SEFs to provide execution methods that may include either an order book (similar to an exchange) or a request for

[14] *https://www2.isda.org/functional-areas/research/research-notes/.*

[15] A request-for-quote system is a type of electronic bidding solicitation in which a requester (*i.e.,* a client) seeks bids from several dealers to provide a price quote for the execution of a particular swap.

[16] *https://www2.isda.org/functional-areas/research/research-notes/.*

quote to a minimum of three participants. Many of our U.S. clients want flexible trading requirements and protocols that will provide competitive and efficient execution based on the unique characteristics of a particular product.

The Dodd-Frank Act does not require that SEFs only execute transactions by means of an order book or a request-for-quote system to three. Such a restrictive interpretation contradicts Congressional intent to allow swaps to be traded by "any means of interstate commerce," discourages trading of swaps on SEFs and hurts pre-trade price transparency.[17] The CFTC's restrictive interpretation makes it difficult to achieve the broad goal of global swaps trading envisioned by the G20 member countries. In Europe, policymakers and regulators intend to allow derivative contracts that are subject to the trading obligation to be traded on a number of centralized venues, which offer more flexible methods of execution than provided for under the CFTC's SEF rules.

There are achievable ways in which to reduce the undesirable regulatory outcomes that threaten the efficient functioning of the swaps markets, reduce barriers to market access for U.S. market participants looking to trade abroad and for non-U.S. market participants wishing to trade efficiently in the United States, and minimize roadblocks to an effective cross-border regulatory regime, while preserving increased transparency and market integrity.

The CFTC should consider amending its rules to allow the CFTC, under certain circumstances, to approve additional methods of execution for Mandated Swaps. In addition, adjusting SEFs' execution models could facilitate a path toward achieving a substituted compliance regime for derivatives trading.

IV. The MAT Process Should Give the CFTC Decision-Making Authority With Regard to Products Mandated To Be SEF Traded, and Market Participants Should Have the Opportunity To Provide Input

Under the current MAT process, a SEF or DCM files with the CFTC, identifying the swap or swaps that will be subject to the CFTC's trading mandate. The only requirements or regulatory standards that the SEF's or DCM's analysis must meet are that: (1) the swaps in the submission must already be subject to mandatory clearing; and (2) the submission must consider one of six factors, broadly defined. Depending on the type of submission, in either 10 or 30 days following the official filing date, the SEF's MAT determination becomes law and applies to all SEFs, DCMs and market participants. SEFs are for-profit entities and this framework does not appropriately balance their commercial interests with the needs of market participants nor does it provide the CFTC with an adequate voice in the approval process. Specifically:

- The MAT process should require SEFs to provide a more granular explanation as to why a particular swap contains the requisite trading liquidity for mandatory trading. For example, SEFs should present additional quantitative and qualitative data as part of their MAT determination assessment.
- The public should be given the opportunity to provide comments to a SEF's MAT determination submission through a public consultation process.
- The CFTC and not SEFs should make the final decision as to when a swap should be considered to be a Mandated Swap.
- The CFTC should view a swap's availability for mandatory trading as a fluid determination. The SEF rules do not provide sufficient flexibility to both SEFs and SEF users to remove a certain swap from a MAT determination if the trading characteristics of the swap change such that it is no longer suited for trading through a SEF's order book or through a request for quote to three participants.

Market participants understand the CFTC is actively evaluating reforms to the MAT process and such refinements would be welcome.

IV. Trading Venue Equivalence Will Reduce the Risk of Further Market Fragmentation and Promote Trading Liquidity Between U.S. and Non-U.S. Markets

Other jurisdictions are at various stages of developing their own trade execution regulatory regimes. For example, the EU is in the process of developing its trading proposals, and its trading obligation is not expected to be implemented until 2018. Notwithstanding that foreign regulatory regimes are in their formative stages, it is encouraging that the CFTC has begun coordinating with foreign regulators to facilitate mutual recognition of trading platforms and trading requirements.

[17] 7 U.S.C. 1a(50) (2015).

To reduce the risk of market fragmentation and to enhance trading liquidity between U.S. and non-U.S. markets, the CFTC should apply the principles outlined in the Final Report issued by IOSCO Task Force on Cross-Border Regulation and recognize and highlight the broad commonalities between the U.S. and foreign regulatory regimes, rather than focus on the more technical, line-by-line differences between the underlying rules.

The CFTC should compare its final trading rules with foreign regulations designed to achieve corresponding regulatory outcomes. Where these requirements are satisfied, the CFTC should provide that the foreign trading venues are exempt from SEF registration and compliance with the SEF rules, and that where a swap is subject to the CFTC's trading mandate, the parties to such a swap may satisfy the obligation to comply with the CFTC's trading mandate by executing such a swap on a foreign trading venue in accordance with applicable rules, regardless of their status as a U.S. person or otherwise.

Congress directed the CFTC to exempt a trading venue from CFTC registration if the CFTC finds that the facility is "subject to comparable, comprehensive supervision and regulation on a consolidated basis by . . . the appropriate governmental authorities in the home country of the facility." This creates concerns about the competitive harm to American companies resulting from differences in final regulations, the gap in implementation dates in Europe and other jurisdictions as well as confusion over the extraterritorial application of these provisions. Congress provided the CFTC with broad authority to exempt platforms to adopt such a restrictive approach to mutual recognition. To that end, market participants see this authority as a helpful mechanism by which Congress intended the CFTC to pursue a more flexible approach based on global regulatory collaboration.

The work the CFTC and EU regulators have undertaken to date discussing these issues is important. In February 2016, both regulators announced the U.S./EU Common Approach, which market participants hope will result in greater harmonization of global trade execution standards.

Conclusion

We thank the Committee for the opportunity to share this perspective and we offer our assistance to policymakers in addressing issues that promote the viability of markets critical to end-users and economic growth.

With the implementation of mandatory central clearing, CCPs have become an increasingly important component in the overall safety and soundness of the financial system. It is therefore critical that policymakers and market participants ensure the risk management frameworks in place at CCPs are sufficiently robust to reflect this enhanced role, particularly as central clearing is no longer optional for many market participants seeking to manage risk.

Similarly, it is important for regulators to review the various new requirements, with regard to both market reforms and new prudential standards, to understand any interconnections and ensure objectives are aligned. The leverage ratio's failure to recognize the exposure reducing effect of initial margin for client clearing is an example where regulatory objectives are at odds and it is already manifesting in reduced access to clearing services for some market participants.

Last, minor adjustments to the CFTC's SEF rules would support market efficiency, while maintaining the core objectives of enhanced transparency and market integrity.

The CHAIRMAN. All right, thank you, Ms. Rosenberg.

Mr. Merkel.

STATEMENT OF STEPHEN M. MERKEL, J.D., EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY, BGC PARTNERS, INC.; DIRECTOR, WHOLESALE MARKETS BROKERS' ASSOCIATION, AMERICAS, NEW YORK, NY

Mr. MERKEL. Thank you, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee.

My name is Stephen Merkel. My company, BGC Partners, is a leading global intermediary to the wholesale financial markets. I am testifying today as a Director and former Chairman of the Wholesale Markets Brokers' Association, Americas, an independent industry body, representing the largest interdealer brokers. Each of our members has a CFTC-registered swap execution facility, or SEF.

Mr. Chairman, it has been a long, strange trip, from the early versions of what would ultimately result in the Dodd-Frank Act, to the current state of affairs. Generally speaking, nothing has gone as planned.

The SEF rules demonstrate an interpretation inconsistent with the new Commodity Exchange Act statutory authority. The subsequent SEF registration process highlighted numerous defects in the rules. As a result of these detours, we found, and find, ourselves in an environment of regulatory uncertainty, fragmented liquidity, and a need for course corrections by the CFTC.

Looking forward, and putting it simply, we all need to support the CFTC to fine-tune its rules and enjoy harmonious relationships around the world.

I credit highly the dedicated CFTC staff who completed an enormous amount of work, designing and implementing the architecture for a regulatory regime. CFTC staff has helped us through the registration process to become a SEF, accommodated us through the issuance of no-action letters, staff guidance, and interpretative statements. Unfortunately, this reactive and *ad hoc* process cannot easily cover every problem or need, and fails to provide the same regulatory certainty as APA compliant rules.

My written testimony references a series of outstanding substantive issues that need to be resolved. We are encouraged by Chairman Massad's recent statement that CFTC will seek to codify the existing no-action letters under the formal rulemaking process, and we urge them to address a wider set of issues in that release.

There have also been pronounced market implications. Liquidity has fragment by jurisdiction as non-U.S. participants seek to avoid Dodd-Frank.

My written testimony cites the recent ISDA research and the Bank of England staff study on this point. The research warns that there is no sign of this trend reversing.

This arrangement is not sustainable, nor is it consistent with the visions set forth in Pittsburgh in 2009. Because this is a new regulatory framework, the CFTC should regularly analyze market data to study the impact of its rules. If ISDA and the Bank of England can do this, the CFTC should too. The research should be published, conclusions publicly commented on, and the resulting product should inform future policy initiatives.

The path forward for any future mutual recognition process will need to resolve the awkward regulatory relationship among jurisdictions. Current comparison of Dodd-Frank in MiFID II raises questions about whether the two can coexist, including the CFTC's past failed attempt to institute a qualified multilateral trading facility regime.

There are also divergent approaches to the permitted methods of execution with, for example, MiFID explicitly identifying auction protocols. Furthermore, the CFTC's reliance on no-action relief is a procedural tool that is not recognized in Europe.

Mr. Chairman, I hope this Subcommittee will encourage the CFTC to make mutual recognition and equivalency a high priority.

I would be pleased to answer your questions. Thank you.

[The prepared statement of Mr. Merkel follows:]

PREPARED STATEMENT OF STEPHEN M. MERKEL, J.D., EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY, BGC PARTNERS, INC.; DIRECTOR, WHOLESALE MARKETS BROKERS' ASSOCIATION, AMERICAS, NEW YORK, NY

Introduction

Chairman Scott, Ranking Member Scott, 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 of BGC Partners, Inc. ("BGC Partners"), a leading global intermediary to the wholesale financial markets, specializing in the brokering of a broad range of financial products, including fixed income, interest rate derivative, foreign exchange, equity, equity derivative, credit derivative, listed futures, commodity, and structured product markets. BGC Partners was created in August 2004, when Cantor Fitzgerald separated its voice and electronic interdealer brokerage business from its dealer activities.

I am testifying today in my capacity as a Director and former Chairman of the Wholesale Markets Brokers' Association, Americas (the "WMBAA"), which represents BGC Partners, GFI Group, Tradition, and Tullett Prebon.[1] Each of the WMBAA member firms has registered a swap execution facility ("SEF") with the Commodity Futures Trading Commission ("CFTC"). For each of the last 7 years, we have collectively hosted a 1 day conference in Washington or New York appropriately entitled "SEFCON" that explores the top issues facing our industry and over-the-counter ("OTC") markets from both a domestic and global perspective. The WMBAA extends thanks to the Chairman and other Members of the Agriculture Committee who have attended and shared their thoughts at this marquee event.

Thank you for inviting me to speak with you about the ongoing implementation of the September 2009 Pittsburgh G20 commitments to improve OTC derivatives markets.[2] The WMBAA remains supportive of coordinated global efforts to promote trading on regulated venues, central counterparty clearing, and public reporting of standardized OTC derivative contracts in order to "improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."[3]

I welcome the chance to update you from the WMBAA's perspective as it relates to implementation of trade execution regulations and the impact on global market conditions.

In my written testimony, I will focus on the following points:

- First, the primary driver of the G20 commitments was to address systemic risk to our financial system. Trade execution in and of itself was not and has never been singled out as contributing to the financial crisis.
- Second, while not without challenges or material shifts in pre-existing market structure, markets are gradually adjusting to the new regulatory landscape and the new SEF trading environment. There remain significant efforts to ensure a globally coordinated approach is ultimately put in place. The CFTC should continue to review its rules, analyze their impact on market conditions, with quantifiable metrics, and adjust the regulations as appropriate.
- Third, important lessons should be learned from the prolonged clearinghouse mutual recognition negotiations so that trade execution venues do not have to endure the same experience. With liquidity provision services offered by SEFs in the United States ("U.S."), multilateral trading facilities ("MTFs"), soon to be recognized organized trading facilities ("OTFs") in Europe, introducing brokers, traditional broker-dealers, and others, global regulators should more carefully coordinate regulatory efforts so as to not fragment markets, reduce liquidity,

[1] The WMBAA is an independent industry body representing the largest inter-dealer brokers. The founding members of the group—BGC Partners, GFI Group, Tradition, and Tullett Prebon—operate globally, including in the North American wholesale markets, in a broad range of financial products, and have received permanent registration as swap execution facilities. The WMBAA membership collectively employs approximately 4,000 people in the United States; not only in New York City, but in Stamford and Norwalk, Connecticut; Chicago, Illinois; Jersey City and Piscataway, New Jersey; Raleigh, North Carolina; Juno Beach, Florida; Burlington, Massachusetts; and Dallas, Houston, and Sugar Land, Texas. For more information, please see *www.wmbaa.com*.

[2] *See* Leaders' Statement, the Pittsburgh Summit, September 24–25, 2009, available at *https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf*.

[3] *Id.*

and increase costs to users by rupturing the existing methods by which U.S. and non-U.S. swap dealers, international banks, global asset managers, and end-users access competitive, transparent OTC markets in the U.S. or in other jurisdictions. We have already witnessed liquidity move across borders. Global regulatory gaps have not only promoted bifurcation of trading patterns but can be exploited to the detriment of investors.

- Finally, while some key implementation issues remain with the CFTC's SEF rules, and I will highlight several today, the WMBAA remains hopeful that many of these outstanding issues can be resolved by the regulatory agencies. I will explain how the CFTC interpreted clear Congressional intent to fashion a flexible swap trading regime into a prescriptive, artificially restrictive rule set and, to date, has not fully evaluated the impact of its rules on market quality. Although continued oversight and vigilance, such as this hearing, remain needed on an ongoing basis, it is also our hope that that Congress will not have to be called upon to reiterate through new legislation its previously stated desire for a flexible, technology-neutral trade execution framework that encourages innovation and fosters liquidity formation.

I. The Transition to OTC Trading on Regulated Platforms Is Proceeding, But Not Without Challenges

While the CFTC's SEF rules were implemented in 2013, the first "made available to trade" or "MAT" determination did not become effective until February 2014. That determination, which can only be initiated by a SEF petition, is the first step towards requiring that a certain swap be traded on a SEF. Currently, the mandatory trade execution requirement only applies to certain interest rate and credit default swaps. Accordingly, in those markets, we have seen increased market reliance on SEFs to facilitate trading in these products.

Indeed, a recent International Swaps and Derivatives Association ("ISDA") study found that more than ½ of average daily interest rate derivatives trading activity was executed on a SEF during the first quarter.[4] For the credit default swap index market, SEF trading accounted for 78.8% of average daily trade counts and 78.1% of average daily notional volume.[5]

These statistics, coupled with statements of support for regulated, transparent intermediation of OTC derivatives by the buy-side institutions such as mutual funds, pension funds, insurance firms,[6] and other market participants suggest a broad adjustment to rules implemented in support of the G20 mandate to promote regulated swap trade execution as a replacement for purely bilateral trade activity.

However, while the ISDA research indicates that market participants have migrated towards regulated intermediation in selected marketplaces, there are serious global market structure issues across the derivative markets generally that remain unresolved.

In the U.S., for example, there are now 21-fully registered SEFs, one temporarily-registered SEF, and two SEFs with applications still pending. This means, just in the U.S. alone, domestic market participants must choose among 24 different venues to access liquidity. For each SEF, market participants have to review and compare individual rule books, analyze different cost structures, and complete the legal and technical components of onboarding before executing the first trade.

While the ISDA statistics and large number of recently-registered SEFs may suggest a smooth transition to the SEF regime, I will share with the Subcommittee some of the troublesome compliance and interpretative issues related to swap trading that still remain. Some of these issues will likely be dealt with through CFTC staff interpretation of existing regulations and others will require changes to the rules. Regardless, the complexities of connecting market participants—with varying technological sophistication and available resources—with SEFs, clearinghouses, credit hubs, swap data repositories, and other critical market infrastructure, require agreement among these entities about how to best comply with the ruleset adopted by the CFTC, as well as those forthcoming rules from the Securities and Exchange Commission ("SEC") for security-based swaps and corresponding regulation in Eu-

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[4] *See* ISDA *SwapsInfo First Quarter 2016 Review,* June 2016 (stating "[m]ore than half of average daily IRD trading activity was executed on a [SEF] during the first quarter: 52.6% by trade count and 56.0% by notional volume"), available at *http://www2.isda.org/attachment/ODQxNg==/SwapsInfo%20First%20Quarter%202016%20Review%20.pdf.*

[5] *See id.*

[6] *See* Letter from Timothy W. Cameron and Lindsey Weber Keljo, Asset Management Group, Securities Industry and Financial Markets Association to the CFTC, May 11, 2015, available at *http://www.sifma.org/commentletters/2015/sifma-amg-submits-comments-to-the-cftc-in-response-to-commissioner-giancarlo-s-white-paper-and-in-regards-to-the-sef-regulatory-framework/.*

rope and Asia. With more clarity from regulators and consensus among market participants, the smoother the ongoing transition to the new rules will be.

II. The Global Swap Trading Landscape Requires Global Coordination; Any Other Approach Will Harm Financial Markets

A. SEF Rules Have Fragmented Global Market Liquidity

As intermediaries of financial products and operators of regulated exchange venues around the world, WMBAA members have observed firsthand the pronounced fragmentation caused by the CFTC's SEF rules. Anecdotally, we have seen market participants refrain from transacting with counterparties in certain jurisdictions to avoid the CFTC's regulatory burdens.

For example, rather than submit to U.S. regulation, a wide spectrum of non-U.S. entities either withdrew from U.S. trading venues or refused to trade with U.S. person counterparties to reduce activity that would be attributed towards the "swap dealer" or "major swap participant" thresholds which carry significant and costly obligations. As a result, liquidity has been formed by jurisdiction. Trading has become more regionalized with, for example, Euro and British Pound interest rate swaps traded almost exclusively among non-U.S. counterparties and away from SEFs, while U.S. Dollar interest rate swaps are now almost exclusively traded in the U.S.[7]

Last month, ISDA also published its "Second Half 2015 Update" analyzing the cross-border fragmentation of global interest rate derivatives. ISDA concludes that "[t]he fracturing of the global interest rate swaps market that emerged in the aftermath of U.S. [SEF] rules coming into force in October 2013 shows no signs of reversing" and that "some liquidity pools continue to be split on U.S. and non-U.S. lines."[8] Specifically, ISDA found that "91.2% of cleared euro interest rate swap ('IRS') activity in the European interdealer market was transacted between European counterparties in December 2015," compared with 70.7% just before the CFTC's SEF rules went into effect in September 2013.[9]

Other analysis of market data reaches the same conclusion. For instance, a recent Bank of England staff working paper found that:

> the introduction of the SEF trading mandate reduced the proportion of trading taking place between U.S. and non-U.S. persons, particularly for EUR denominated swaps. This suggests that some non-U.S. persons became less willing to trade with U.S. persons as this would require them to trade on a SEF. Thus, an effect of the new regulation was increased geographical fragmentation of the global swap market.[10]

The Bank of England staff did not just identify fragmented markets. The paper also concludes that SEF trading brings benefits to investors. Namely, "as a result of SEF trading, activity increases and liquidity improves across the swap market, with the improvement being largest for [U.S. Dollar] mandated contracts which are most affected by the mandate. The associated reduction in execution costs is economically significant."[11]

B. Policymakers Must Improve the Mutual Recognition Process

While the CFTC SEF registration process may be complete (with the SEC's corresponding security-based SEF regime still outstanding), the impeding MiFID II January 2018 target compliance date makes it vital that any trade execution regulatory gaps among the principal jurisdictions be resolved in the coming months.

This Subcommittee and my fellow witnesses are all familiar with the issue of clearinghouse equivalence, having explored the topic in many prior hearings.[12] We

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[7] *See* ISDA Research Note: *Cross-Border Fragmentation of Global Interest Rate Derivatives: Second Half 2015 Update,* May 2016, available at *http://www2.isda.org/attachment/ODM4NQ==/Fragmentation%20FINAL1.pdf*.

[8] *Id.*

[9] *Id.*

[10] Benos, Evangelos, Richard Payne and Michalis Vasios, Bank of England Staff Working Paper No. 580, *Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act,* available at *http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf*, page 2.

[11] *Id.*

[12] *See* Testimony of Terrance A. Duffy before the House Committee on Agriculture Subcommittee on Commodity Exchanges, Energy, and Credit, *Hearing on CFTC Reauthorization,* March 25, 2015, available at *http://agriculture.house.gov/uploadedfiles/duffy_testimony.pdf; see also* Testimony of Chairman Timothy G. Massad before the U.S. House Committee on Agriculture, February 10, 2016, available at *http://agriculture.house.gov/uploadedfiles/massad_testimony.pdf*.

were pleased to see the announcement of a common approach for central clearing counterparties in February 2016.[13] However, as CFTC Commissioner J. Christopher Giancarlo has noted, the equivalence debate for U.S.-registered SEFs/security-based SEFs *versus* MTFs, OTFs, and other versions of registered trading venues outside the U.S. could lead to another "equivalency standoff."[14]

Furthermore, the CFTC's past efforts to provide a "qualified" MTF regime for execution platforms operating within the EU where U.S. person entities would be allowed to execute off-SEF[15] failed because, among other reasons, the proposed terms allowed the CFTC to unilaterally remove the relief at any time. The proposal also did not attract participants because, under the terms of the relief, an MTF would be required to comply with the CFTC's SEF regime not just for trades involving U.S. counterparties or U.S.-regulated products, but even for trades executed between European counterparties on a European-regulated product through a European trading venue. That expansive overreach went too far for already-regulated market participants to agree to a second layer of regulatory burdens.

Therefore, while multiple EU-based execution venues, including all WMBAA member firms, were prepared to meet the necessary qualifications for both the CFTC and the UK's Financial Conduct Authority, this proposal did not result in any European intermediaries agreeing to submit it and its participants to comprehensive CFTC oversight. The global derivative markets can ill afford a repeat of this scenario in the equivalence negotiations leading up to MiFID II implementation, especially because the European regulatory regime does not offer the flexibility of no-action relief and, therefore, an avoidable polarization of liquidity pools may become permanent if an agreement is not reached prior to January 2018. We urge the Subcommittee to prioritize execution equivalence as the primary tool to counter the increasingly well-entrenched trend for liquidity to be split along regional lines.

As we have seen, the paralyzing impact this delay in coordination and overall uncertainty can bring to clearinghouses with the accompanying segregation of trading, the same (if not worse) could happen if the current opportunity to shape execution equivalence between the U.S. and the EU is squandered. Of course, the costs will be borne by liquidity providers, asset managers, and end-users who rely on intermediaries to provide this vital function, as they will receive fragmented, less competitive bids and offers due to barriers erected by uncoordinated cross-border rules. All of these artificial blockages to natural liquidity formation result in higher costs to investors who are meant to be the ultimate beneficiary of the reforms instituted by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[16]

Subsequent to the G20 summit in Pittsburgh and well before the adoption of the Dodd-Frank Act, WMBAA members and other trading firms were preparing for what would ultimately result in the current SEF regime. There has been nearly a decade of time, energy, and resources devoted to post-financial crisis regulatory reform that has been replicated in other G20 jurisdictions. These parallel work streams should have resulted in a comprehensive, consistent, and coordinated global oversight framework that promotes market liquidity and function while meeting public policy objectives.

Yet, to date, that has not occurred. Some global financial services companies have created and registered separate entities in various jurisdictions purely to avoid being subject to SEF terms and conditions. Some intermediaries have submitted their European platforms for U.S. oversight in a splintered fashion. And, most recently, the CFTC received an application for a jointly-registered SEF and MTF. While market participants remain tentative and unsure as to how the G20 global trade execution implementation permutations will play out, this also suggests uncertainty among the trading venues themselves.

III. Examples of Necessary Regulatory Improvements to the CFTC SEF Regime

The WMBAA has long publicly supported a flexible, principles-based approach to the implementation of the Dodd-Frank Act trade execution framework. In that light, we continue to harbor reservations about some of the technical points related to the

[13] *The United States Commodity Futures Trading Commission and the European Commission: Common approach for transatlantic CCPs,* February 10, 2016, available at *http://www.cftc.gov/idc/groups/public/@newsroom/documents/speechandtestimony/eu_cftcstatement.pdf*.

[14] *See Six Month Progress Report on CFTC Swaps Trading Rules: Incomplete Action and Fragmented Markets,* August 4, 2015, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement080415*.

[15] CFTC No-Action Letter No. 14–46, April 9, 2014, available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-46.pdf*.

[16] Public Law 111–203, 124 Stat. 1376 (2010).

CFTC's interpretation of certain provisions of the Dodd-Frank Act and the staff's reading of the implementing regulations in terms of satisfactory policies and procedures. Furthermore, while other global regulatory bodies and industry associations, like the Bank of England and ISDA, have engaged in an empirically-based evaluation of the swap trading rules on market conditions, the CFTC has not yet published any data-driven analysis of their own rules. We strongly believe that should be completed, published for market feedback, and result in appropriate changes to the rules.

As I said at the outset, we remain hopeful that many of these can be resolved at the agency level. But we very much appreciate this Subcommittee's interest in these very important issues and its continued oversight of the CFTC's work.

The current mix of statute, rules, no-action letters, staff guidance, and interpretive statements does not provide sufficiently predictable regulatory certainty for SEFs to plan, invest, and grow domestically or to be able to incorporate SEF activity within global operations. As long-standing businesses placed under a novel regulatory scheme, it is vital to know objectively not just the practical implications of rules but how they may be interpreted on a permanent basis similar to rules adopted under the Administrative Procedure Act. Staff or Division letters and guidance are informative, but can be revoked or amended at any time without any due process protections. The Subcommittee should remain aware of the Commission's reliance on these measures and protect against their overuse.

Chairman Massad has said, even recently, that the CFTC has "fine-tuned" some of its rules through no-action letter relief and will "consider a codification of those adjustments, and potentially other changes to enhance SEF trading and participation." [17] The WMBAA welcomes this approach as an initial step as the formalization in rule text provides additional reliability. However, the WMBAA also believes that more substantive, comprehensive changes are likely necessary on a wider range of issues than simply codifying a few existing no-action letters. We agree with Chairman Massad that the CFTC should work to create "the foundation for the market to thrive" and "permit innovation, freedom and competition." [18]

To assist the Commission in its review of changes to enhance SEF trading and participation, in March of this year, the WMBAA submitted a comprehensive list of issues to Chairman Massad. That letter is attached to my testimony today. We look forward to participating in a productive dialogue with Chairman Massad, his fellow Commissioners, and the hard-working CFTC staff.

Briefly, I would like to highlight a few issues set forth in the WMBAA's March 2016 letter.

Explicit regulatory certainty with respect to flexible modes of execution. The SEF definition, as set forth in the Dodd-Frank Act,[19] is intentionally broad, flexible, and contemplates a wide array of execution methods. The implementing CFTC regulation artificially restricts permitted methods of liquidity formation and execution to an order book or request for quote ("RFQ").[20] First, this is problematic because it is inconsistent with the clear language of the statute. Second, this approach may prevent or discourage certain technologies from facilitating trading through a registered SEF. Finally, and importantly given the ongoing work to achieve global harmonization, the restriction on execution methods is narrower than those clearly permitted under MiFID II, which may ultimately drive derivatives trading away from the U.S.

The WMBAA urges the CFTC to make clear that SEFs may operate other protocols besides order books or RFQs, including Trading Facilities, under the Commodity Exchange Act ("CEA"). For example, auction-type systems such as BGC Partners' VolumeMatch meet the CEA definition of trading facility and, therefore, should be explicitly permitted as an acceptable execution method for Required Transactions. It has been our experience that these new trading protocols continue

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[17] Statement of Chairman Timothy Massad before the CFTC's Market Risk Advisory Committee, April 26, 2016, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement042616*.

[18] Remarks of Chairman Timothy Massad before the ISDA 30th Annual General Meeting, April 23, 2015, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-17*.

[19] *See* CEA § 1a(50) ("a 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, including any trading facility, that—(A) facilitates the execution of swaps between persons; and (B) is not a designated contract market.").

[20] The traditional RFQ trading protocol, where a single market participant solicits a bid or offer from at least three other market participants, seems to fall short of the "multiple to multiple" component of the SEF definition.

to gain favor in the marketplace as an alternative to order book and RFQ trading and more effectively promote competitive price discovery for interested parties.

Made Available to Trade. The WMBAA believes the MAT process should be amended. While SEFs should commence the review through the filing of the petition, the petition's approval should not be a "negative consent" process. The CFTC's Part 40 rules' 10 day negative consent process starts with a presumption of approval and removes any real discretion or judgment from the CFTC's hands. The MAT determinations are important and should benefit from more careful analysis of a wider set of information rather than being subject to the single submission of an individual SEF.

Rather, the CFTC should have the responsibility of making the determination based on objective criteria and subject to public notice and comment on the petition. The factors that the CFTC considers in deciding whether to impose a SEF trading mandate should be consistent with the process and analysis followed by other global financial market regulators in order to prevent any bifurcation of the swap markets and regulatory arbitrage.

SEF Position Limit or Position Accountability Regimes. The Dodd-Frank Act requires SEFs to "adopt for each of the contracts of the facility, as is necessary and appropriate, position limitations or position accountability for speculators" and then to "[m]onitor positions established on or through the [SEF] for compliance with the limit set by the Commission and the limit, if any, set by the [SEF]."[21] The WMBAA and the broader SEF community, including a SEF chief compliance officer working group, have engaged with the CFTC on this issue. Both the National Futures Association and the WMBAA have authored white papers on the topic.

Simply put, SEFs, as competitive trading platforms, do not possess information about a trader's overall position in any given swap or its underlying instrument or commodity because of the inherently competitive nature of swap trading. A SEF is not a centralized exchange; each SEF is one of multiple competitive platforms facilitating trading activity in fungible financial products that can and does move easily from one venue to another. Unlike listed futures and options where trading and clearing is vertically integrated and each centralized exchange has information about positions in the marketplace for any specific contract, each SEF only has information about swap transactions that take place on its individual facility and has no access to information as to whether a particular trade on the facility adds to an existing market-wide position or whether it offsets all or part of an existing position in that swap.

The CFTC should specify that SEFs are not obligated to impose position limits or accountability until such time as the CFTC determines that such measures are "necessary and appropriate," especially because unified position information is available at the swap data repository level where all SEF trade data is maintained. Further, implementing position limitations or position accountability is not necessary and appropriate at this time because, it has not been proven that such limits are an effective tool for detecting and preventing manipulation and other abuses for swaps.

SEFs accept and take seriously their obligation as market operators to ensure they provide reliable, resilient venues to access competitive pricing. This includes monitoring for manipulation and other abusive trading activity that takes place on each individual facility which will continue in earnest as part of our responsibility to meet existing SEF core principles.

SEF Financial Resource Requirements. The CEA requires all SEFs to have "adequate financial, operational, and managerial resources." During the SEF registration review process, we learned that CFTC staff believe that all SEF employees are considered part of the SEF's financial obligation, regardless of the employment arrangement (*e.g.,* at-will, contractual, or guaranteed salary). As a result, SEFs with voice-based systems face significantly higher financial resources commitments than those facilities that only provide electronic trading access. The Dodd-Frank Act does not dictate this outcome. From a public policy standpoint, it prevents investment and growth if a SEF must freeze capital to help pay at-will or contracted staff for a full year when, in reality, the SEF does not have that liability to simply "discharge each responsibility of the [SEF]."

We continue to discuss with the CFTC and staff a more realistic, flexible interpretation that promotes all types of swap trading and only attributes the financial resource requirement to cover the fixed costs associated with compliant SEF operation and solely those required to ensure compliant operations. We think that is a more appropriate approach than factoring in variable costs and costs related to staff that are not core to a compliant operating structure and who would not be associated

[21] CEA § 5h(f)(6).

with the SEF for the currently-required 12 month timeframe in the event of a change to the business. One possible solution involves relying on a rule provision that delegates the CFTC's authority on this issue to the Director of the Division of Market Oversight. We look forward to continued engagement with the CFTC on this issue.

IV. Conclusion

Mr. Chairman, the WMBAA appreciates the opportunity to appear today and discuss the ongoing work to implement the G20 mandates. We look forward to continued work on these developments with Congress, the CFTC, the SEC, and regulatory bodies around the world.

I would be pleased to answer any questions you may have.

APPENDIX

March 11, 2016

Hon. TIMOTHY MASSAD,
Chairman,
Commodity Futures Trading Commission,
Washington, D.C.

Re: **Swap Execution Facility Regulations, Made Available to Trade Determinations, and Swap Trading Requirements**

Dear Chairman Massad:

Since the promulgation of the regulations governing swap execution facilities ("SEFs") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Commissioners of the Commodity Futures Trading Commission ("CFTC" or "Commission") have discussed the Commission's consideration of potential revisions to various aspects of its swap regulations, including those reforms related to SEFs and trade execution. For example, you have stated that the Commission is "focused on issues concerning trading on [SEFs]," and that you "will ask the Commission to consider a number of rule changes to enhance SEF trading and participation." [1] Calls for the Commission to consider potential revisions to its Dodd-Frank Act regulations have also been raised by Commissioner Bowen [2] and Commissioner Giancarlo.[3] In addition, Commission staff has indicated that they are considering potential no-action relief or guidance with respect to issues that market participants have identified as problematic.

The Wholesale Markets Brokers' Association, Americas ("WMBAA") [4] appreciates the Commission's careful and deliberative approach to the regulation of SEFs and extends its appreciation to the Commission for granting permanent registration to each of the member firms' SEFs earlier this year. This milestone represents a significant step toward firmly establishing the regulatory regime for mandatory trade execution as envisioned by the Dodd-Frank Act and providing market participants with further much-needed regulatory certainty. Against the backdrop of permanent SEF registration, the WMBAA looks forward to continuing to work with the Com-

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[1] *See* Keynote Remarks before the Institute of International Bankers Annual Washington Conference (Mar. 7, 2016).

[2] *See* Statement of Commissioner Bowen, Dec. 1, 2014 (stating that "the best way of viewing changes to [the CFTC's Dodd-Frank Act rulemakings] is not that [the CFTC is] tweaking them, but rather that [the CFTC is] enhancing them. Sometimes that may mean making the rules more cost-effective and leaner, but at other times that will mean making them stronger than before. Enhancing a rule can mean reducing burdens to business while strengthening protections for the public"), available at ***http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement120114***.

[3] *See* Commissioner Giancarlo White Paper, "Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank" (Jan. 29, 2015), available at ***http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf; see also*** Statement of Commissioner Giancarlo, ***Six Month Progress Report on CFTC Swaps Trading Rules: Incomplete Action and Fragmented Markets*** (Aug. 4, 2015), available at ***http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement080415***.

[4] The WMBAA is an independent industry body representing the largest inter-dealer brokers. The founding members of the group—BGC Partners, GFI Group, Tradition, and Tullett Prebon—operate globally, including in the North American wholesale markets, in a broad range of financial products, and have received temporary registration as swap execution facilities. The WMBAA membership collectively employs approximately 4,000 people in the United States; not only in New York City, but in Stamford and Norwalk, Connecticut; Chicago, Illinois; Jersey City and Piscataway, New Jersey; Raleigh, North Carolina; Juno Beach, Florida; Burlington, Massachusetts; and Dallas, Houston, and Sugar Land, Texas. For more information, please see *www.wmbaa.com*.

mission and its staff on all matters pertaining to SEFs, including on any future CFTC rulemakings, amendments, guidance, or interpretations related to trade execution and SEFs, to ensure that the regulations are implemented in accordance with the underlying statutory intent and accomplish the Dodd-Frank Act's goal of "promot[ing] the trading of swaps on swap execution facilities."

The WMBAA supports the Commissioners' recognition that the regulations should be assessed and reconsidered on an ongoing basis. In particular, the WMBAA supports Commission efforts to "formalize through notice-and-comment rulemaking a number of the 'no-action' positions the staff has taken, such as simplifying the confirmation process, streamlining the process for correcting error trades, and others."[5] We support the regulatory certainty that formal rule changes would provide to issues related to SEF confirmation and reporting, trades deemed void *ab initio,*[6] and trading of block trades "on facility." The WMBAA also recognizes that certain reporting requirements may merit reconsideration, including the "embargo rule," and would welcome the opportunity to discuss such issues further with the Commission.

Further, to assist the Commission and its staff in its assessment of the SEF regulations, the WMBAA respectfully offers the attached matrix in *Appendix A,* which we have prepared based on our expertise as over-the-counter market operators for over 25 years and a combined tenure in the industry of over 100 years, and our experience to date with the implementation of the SEF related rules. For each of the following topics, the matrix notes the relevant statutory provision, describes the implementation issue experienced by market participants, references the relevant CFTC rule or staff advisory, and suggests a potential recommendation to address the issue. The topics are not presented in order of importance, but rather represent the regulatory implementation issues that the WMBAA members are addressing:

- Methods of execution;
- Made available to trade process;
- Audit trail requirements for voice-based executions;
- Position limits;[7]
- Financial resource requirements;
- Cross-border issues;
- Margin requirements;
- Embargo rule; and
- SEF record-keeping requirement.

In addition to the specific issues addressed in the matrix, the WMBAA recommends that the Commission examine the commercial impact of its SEF regulations and other rules on the swap market. Specifically, wherever possible, the Commission should seek to ensure a level playing field between the futures and swap markets for commercially-equivalent risk management contracts by not permitting any unfair regulatory advantage to either market. The WMBAA believes that such regulatory instances, in which a swap market requirement that results in additional costs or creates disincentives for trading swaps relative to the futures market equivalent, should be reconsidered by the Commission.

Last, to the extent that Commission action to modify certain swap-related regulations are constrained by statutory language under the Dodd-Frank Act, the WMBAA would welcome the opportunity to work with the Commission to advocate for appropriate legislative changes before Congress. However, the attached list includes solely those issues which the WMBAA believes can be addressed through regulatory action.

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[5] *See* Keynote Remarks of Chairman Massad before the Institute of International Bankers Annual Washington Conference (Mar. 7, 2016).

[6] Revised regulations should permit SEFs to correct clerical or operational errors on swaps rejected for clearing. In addition, if a swap has been accepted by a DCO for clearing, and a clerical or operational error is subsequently identified, the regulations should permit a SEF to correct the error in the trade without initiating a "new trades, old terms" offset and resubmission, provided that the DCO has the operational capability to permit such a correction.

[7] A WMBAA white paper on position limits, which was submitted to the Division of Market Oversight staff, is attached hereto as *Appendix B.*

We welcome the opportunity to discuss these comments with you at your convenience. Please feel free to contact the undersigned with any questions you may have on our comments.

Sincerely,

WILLIAM SHIELDS,
Chairman, WMBAA.

cc:
The Honorable SHARON BOWEN, *Commissioner;*
Mr. VINCE MCGONAGLE, *Director, Division of Market Oversight.*

APPENDIX A: CFTC PART 37 SEF REGULATIONS: RECOMMENDED REVISIONS

Relevant Statutory Provision	Issue	CFTC Regulation Proposed	Solution/Revision
CEA § 1(a)(50) "The term 'swap execution facility' means a 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, including any trading facility, that— "(A) facilitates the execution of swaps between persons; and "(B) is not a designated contract market."	*Methods of Execution* The SEF definition is broad, flexible, and contemplates execution methods beyond an order book or RFQ system. The CFTC regulation artificially restricts the permitted methods of liquidity formation and execution, which may prevent certain technologies from qualifying as a registered SEF, in contravention to Dodd-Frank's goal of promoting the execution of swaps on SEF. It also does not contain an all-to-all requirement.	Rule 37.9(a)(2) "Execution methods. (i) Each Required Transaction that is not a block trade . . . shall be executed on a [SEF] in accordance with one of the following methods of execution: (A) An Order Book . . . ; or (B) A Request for Quote System . . . that operates in conjunction with an Order Book . . . ."	Add a new clause "(C)" to the execution methods in rule 37.9(a)(2) that expands the permissible methods of execution for Required Transactions to include "or any such other system for trading as may be permitted by the Commission." Codify existing policy that certain systems, including Trading Facilities, fall within the SEF definition and qualify as a permissible method of execution for Required Transactions. Additional methods of execution for Required Transactions should include risk-mitigation. The WMBAA notes that auction-type systems meet the CEA definition of trading facility and, therefore, should be permitted as an acceptable execution method for Required Transactions in their own right and not be subject to the definitions of Order Book or RFQ.
CEA § 2(h)(8) "(A) IN GENERAL.—With respect to transactions involving swaps subject to the clearing requirement of paragraph (1), counterparties shall— (i) execute the transaction on a board of trade designated as a contract mar- ket . . .; or (ii) execute the transaction on a [registered SEF] or a swap execution facility that is exempt from registration . . . (B) EXCEPTION.—The requirements [above] shall not apply if no board of trade or [SEF] makes the swap available to trade or for swap transactions subject to the clearing exception . . . ."	*Made Available to Trade Process* The CEA does not detail a required analysis, enumerate criteria in performing a "made available to trade" analysis, or establish that SEFs or DCMs have the burden of persuading the Commission that a swap should be traded on a registered marketplace.	Rule 37.10(a)(1): "Required submission. A [SEF] that makes a swap available to trade in accordance with paragraph (b) of this section, shall submit to the Commission its determination with respect to such swap as a rule . . . ." Rule 37.10(c): "Applicability. Upon a determination that a swap is available to trade on any [SEF] or designated contract market . . . all other [SEFs] and designated contract markets shall comply with the requirements of section 2(h)(8)(A) of the Act in listing or offering such swap for trading."	Amend the made available to trade (MAT) process so that going forward, SEFs commence the MAT determination process by filing a petition, but the CFTC has the responsibility of making the determination based on objective criteria and subject to public notice and comment on the petition. In addition, as the WMBAA discussed at the recent DMO roundtable, the Commission should harmonize its MAT decisions with those of foreign regulators, including ESMA, in order to prevent any bifurcation of the swap markets and regulatory arbitrage.
CEA § 5h(f)(2)(B)(ii) (Core Principle 2) "A [SEF] shall . . . establish and enforce trading, trade processing, and participation rules that will deter abuses and have the capacity to detect, investigate, and enforce those rules, including means . . . to capture information that may be used in establishing whether rule violations have occurred."	*Voice Audit Trail* CFTC staff has expressed a desire that SEFs must be able to store recordings of oral communications in a digital database and convert such recordings into searchable text. In addition, CFTC staff has explored the concept of requiring SEFs to record or access not only the communications between the SEF's employees and their customers, and any communications between employees, but also the communications of Introducing Brokers. Introducing Brokers already have the obligation under NFA rules to record communications and SEFs have access to such information pursuant to their rulebooks.	Rule 37.205 Commission rule 37.205 sets forth the audit trail requirement for SEFs to "capture and retain all audit trail data necessary to detect, investigate, and prevent customer and market abuses." The Commission requires that such data is "sufficient to reconstruct all indications of interest, requests for quotes, orders, and trades within a reasonable period of time and to provide evidence of any violations of the rules of the [SEF]." Further, an audit trail must also permit a SEF to "track a customer order from the time of receipt through fill, allocation, or other disposition, and shall include both order and trade data." The elements of an acceptable audit trail program involve (1) original source documents, (2) electronic transaction history database, (3) electronic analysis capability, and (4) safe storage capability.	Revise the rules or provide guidance related to audit trail requirements for voice-based executions on SEFs to account for the unique characteristics of voice execution and to recognize the currently available technologies. Any such new rules or guidance would supplement the existing audit trail requirements that are tailored to electronic execution and should more accurately reflect a "technology-neutral" approach to SEF execution. In accordance with the preamble discussion to the final rule, the WMBAA believes that "the intent of the final rules is to require that a SEF establish and maintain an effective audit trail program, not to dictate the method or form for maintaining such information. *Importantly, the rule, by not being prescriptive, provides SEFs with flexibility to determine the manner and the technology necessary and appropriate to meet the requirements*" (emphasis added). 78 *Fed. Reg.* 33,476, 33,518 (June 4, 2013). The WMBAA further recommends that the CFTC consider whether the audit trail requirements may be satisfied based on exception or risk-based SEF reviews.

CEA § 5h(f)(6) (Core Principle 6) "(a) . . . a [SEF] that is a trading facility shall adopt for each of the contracts of the facility, as is necessary and appropriate, position limitations or position accountability for speculators. (b) POSITION LIMITS. For any contract that is subject to a position limitation established by the Commission . . . the [SEF] shall: (1) Set its position limitation at a level no higher than the Commission limitation; and (2) Monitor positions established on or through the [SEF] for compliance with the limit set by the Commission and the limit, if any, set by the [SEF]."	*Position Limits* SEFs do not possess information about a trader's position in any given swap or its underlying instrument or commodity. Rather, SEFs only have information about swap transactions that take place on their individual facilities and have no way of knowing whether a particular trade on the facility adds to an existing market-wide position or whether it offsets all or part of an existing position in that swap. In addition, if SEFs were required to adopt position limits, market participants might abuse such limits. For example, if five SEFs that offer a particular product set their respective limits at a level established by the CFTC, the overall aggregate position available to market participants via trading on such SEFs would be five times greater than the level set by the CFTC. As such, market participants could take advantage of this structure by spreading their transactions across multiple SEFs and DCOs when reaching the limit set by each. While staff has acknowledged that, *in lieu of* position limits, SEFs may establish accountability provisions related to trades rather than positions, the details of such accountability mechanisms and how accountability levels would be set are yet unclear.	Rule 37.600 *Same as statutory provision*	Specify that SEFs are not obligated to impose position limits or accountability until such time as the **Commission** determines that such measures are "necessary and appropriate." Implementing position limitations or position accountability is not necessary and appropriate at this time because, for example: (1) unlike futures and options where trading and clearing is vertically integrated and each DCM has information about positions in the marketplace for any specific contract, they are not an effective tool for detecting and preventing manipulation and other abuses for swaps; and (2) individual SEFs do not possess information about a trader's position in any given swap and, therefore, have no basis of reference as to how and when a position limit should be set. In addition to these comments, the WMBAA has submitted to the Division of Market Oversight ("DMO") staff a white paper explaining why a SEF position limits and position accountability regime is neither necessary nor appropriate.[8] Rather than imposing a position limits regime, the WMBAA respectfully reminds the Commission that a SEF is subject to regulatory requirements to provide data to the Commission, including data related to the trading activity on the SEF, to assist the Commission with monitoring compliance with Federal speculative position limits.[9] A SEF CCO working group, consisting of CCOs of 18 then-provisionally registered SEFs, commissioned the National Futures Association ("NFA") to conduct a study regarding swap position limits and position accountability. The NFA study suggested that the swap market might not lend itself to notional transaction size position or accountability levels at the SEF level. While this study did not offer an official disposition as to the necessity or appropriateness of position accountability levels at the SEF level, it presented data suggesting that such position limits or accountability levels will do little to "reduce the potential threat of market manipulation or congestion," the stated goal of the Core Principle. The SEF CCO working group provided DMO staff with a synopsis of this study in the form of a discussion document. As an alternative to the above proposed solution, the WMBAA would welcome specific guidance on how SEFs can practically comply with an accountability provision, reflecting that: (1) SEFs do not possess position information; and (2) swaps are fungible in terms of being traded on multiple venues and cleared by multiple DCOs. Any accountability level(s) should be established by the CFTC, taking into account the entirety of market activity in a product (both on and off SEFs), and such established level(s) should be applied uniformly to all SEFs.

[8] The WMBAA white paper is attached as *Appendix B*.

[9] This approach was endorsed by a group of SEFs. *See* SEF CCO Group Discussion Document Regarding SEF Core Principle 6—Position Limits and Position Accountability (May 21, 2015).

APPENDIX A: CFTC PART 37 SEF REGULATIONS: RECOMMENDED REVISIONS—CONTINUED

Relevant Statutory Provision	Issue	CFTC Regulation Proposed	Solution/Revision
CEA § 5h(f)(13) (Core Principle 13) "(A) IN GENERAL.—The [SEF] shall have adequate financial, operational, and managerial resources to discharge each responsibility of the [SEF]. (B) DETERMINATION OF RESOURCE ADEQUACY.—The financial resources of a [SEF] shall be considered to be adequate if the value of the financial resources exceeds the total amount that would enable the [SEF] to cover the operating costs of the [SEF] for a 1 year period, as calculated on a rolling basis."	*SEF Financial Resources* CFTC staff has indicated its preliminary belief that all SEF employees are considered part of the financial obligation, regardless of the employment arrangement, *e.g.*, at-will, contractual, and guaranteed salary. As a result, SEFs with voice-based systems face significantly higher financial resources commitments than those facilities that only provide electronic trading access. The Commission's rules do not recognize that: (1) SEFs do not possess or maintain client funds or open interest; (2) there is no practical need for any individual SEF to maintain sufficient resources for a period of 1 year after an event that results in the closure of a SEF, as a SEF could wind down its operations in a much shorter time period; and (3) for SEFs with voice brokers, such voice brokers are not necessary to ensure operation of a compliant SEF and could be removed at any point and for any reason without impacting the SEF's ability to satisfy the Core Principles.	Rule 37.1300 *Same as statutory provision*	Flexibly interpret the SEF financial resources requirements to reflect that SEFs are execution venues only and do not ensure contract performance, making their commercial viability less relevant on a post-transaction basis. As the Commission has delegated authority to the DMO Director on issues pertaining to SEF financial resources, the WMBAA looks forward to working with Commission staff to appropriately account for the following considerations in refining the SEF rules, including with respect to creating an appropriate methodology for computing projected operating costs. See Rule 37.1307. The SEF financial resources requirement should focus on the fixed costs associated with compliant SEF operation and solely those required to ensure compliant operations, rather than the variable costs and costs related to staff that are not core to a compliant operating structure. The WMBAA notes that the costs associated with employing SEF brokers constitute variable costs and are not core to the compliance regime and the operations of a SEF, or necessary or required to operate a compliant SEF, as is demonstrated by other registered SEFs that do not employ brokers. Therefore, costs related to employing SEF brokers should be excluded from the financial resources calculation. Contrary to DMO letter 15–26, any salary or compensation for SEF employee-brokers should not be included in the calculation of projected operating expenses. In addition, the WMBAA has submitted information to DMO staff regarding liquid assets and would welcome any further communication as needed for a rule revision to reduce the burden from 6 months' liquid assets to 3 months' liquid assets. Any modification of the financial resource rules should take into account the fact that the exit of an individual SEF (or brokers within an operational SEF) would not have broad market-wide or systemic effects on the swap marketplace. This is because the trades previously executed on the SEF would have been fully processed and reported, and the positions resulting from all trades would be unaffected, as they are held either at a DCO for cleared trades or with the counterparties for uncleared trades. Moreover, if a SEF were to experience difficulty or choose to exit the marketplace, the wind-down process would occur quickly. As SEFs do not hold positions, the unwind process would take no longer than a few months.

CEA § 2(i) "The provisions of this Act relating to swaps . . . (including any rule prescribed or regulation promulgated under that Act), shall not apply to activities outside the United States unless those activities— (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act . . . ."	*Cross-Border Concerns* The scope of the Commission's cross-border guidance is far reaching such that a permitted transaction involving two non-U.S. counterparties may be subject to SEF execution under footnote 88. This interpretation has had the practical effect of bifurcating markets based on the participants' jurisdictions, impeding liquidity and redirecting activity away from SEFs and, as a result, away from U.S. markets and the oversight of U.S. regulators.	DSIO Advisory No. 13–69 "DSIO is of the view that a non-U.S. SD (whether an affiliate or not of a U.S. person) regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements. For the avoidance of doubt, the Division's view would also apply to a swap between a non-U.S. SD and a non-U.S. person booked in a non-U.S. branch of the non-U.S. SD if the non-U.S. SD is using personnel or agents located in the U.S. to arrange, negotiate, or execute such swap." CFTC staff has issued no-action relief letters pertaining to advisory 13–69, including most recently letter 15–48, which extended relief until September 30, 2016.	Address cross-border issues through a formal rulemaking that invites and addresses public comment. Carefully consider the adoption of equivalency or substituted compliance regimes, such as the establishment of an exempt SEF category, to prevent further fracturing of markets by jurisdiction. Provide guidance regarding who is considered a U.S. person for execution purposes and, consequently, what types of transactions may be conducted off-SEF, such as in the following examples: • A foreign branch of a U.S. person conducting a trade solely in a foreign market with a foreign entity; and • A foreign branch of a U.S. prime broker, acting as a prime broker for a foreign customer. If the Commission engages in a rulemaking pertaining to an exempt SEF category, any exempt SEF should be required to comply with all material, transaction-level requirements applicable to SEFs. In addition, the Commission should work with foreign regulators to ensure they have a reciprocity provision for U.S.-registered SEFs. Any such CFTC rulemaking for exempt SEFs should condition the relief for the foreign MTF on the existence of a reciprocity provision in law or regulation of the applicable foreign jurisdiction. In addition, while non-U.S. swap dealers located in the U.S. have received no-action relief from the execution mandate, no corresponding relief has been issued with respect to platforms operating in an execution capacity for such non-U.S. swap dealers located in the U.S., adding to the uncertainty around the implementation of rules. In the interest of stability, no-action relief should be equally granted to participants and platforms where applicable.
CEA § 5b(c)(2)(D)(iv) "MARGIN REQUIREMENTS.—The margin required from each member and participant of a derivatives clearing organization shall be sufficient to cover potential exposures in normal market conditions."	*Margin Requirements* CFTC rules related to margin provide a significant commercial advantage to futures over swaps. Specifically, the CFTC's rules provide a 5 day margin liquidation period for financial swaps, while all futures have a 1 day margin liquidation period.	Rule 39.13(g)(2)(ii): "A derivatives clearing organization shall use models that generate initial margin requirements sufficient to cover the derivatives clearing organization's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the derivatives clearing organization estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time); provided, however, that a derivatives clearing organization shall use: (A) A minimum liquidation time that is 1 day for futures and options; (B) A minimum liquidation time that is 1 day for swaps on agricultural commodities, energy commodities, and metals; *(C) A minimum liquidation time that is 5 days for all other swaps* . . . ." (emphasis added).	Re-examine the Part 39 margin requirement for swaps to reflect a realistic liquidation time period for swaps. Margins should be based on the economic characteristics of the products, rather than on whether a product is classified as a future or a swap. Products with similar risk profiles should have the same margin requirements.

APPENDIX A: CFTC PART 37 SEF REGULATIONS: RECOMMENDED REVISIONS—CONTINUED

Relevant Statutory Provision	Issue	CFTC Regulation Proposed	Solution/Revision
CEA § 2(a)(13)(D) "The Commission may require registered entities to publicly disseminate the swap transaction and pricing data required to be reported under this paragraph."	*Embargo Rule* As a result of the embargo rule, SEFs and DCMs that would like to continue to permit work-ups may face workflow issues because they cannot share trade information with their customers until such information is transmitted to an SDR. Such delays can have a material effect on market liquidity. To operate efficiently and competitively, information which reflects current market activity must be available to all market participants without any disruptive pauses for the occurrence of other regulatory activities. Every market participant must have real-time information on executed trades for the entire marketplace to ensure effective price discovery so that they can make informed trading decisions. This allows the market to operate properly as a single liquidity pool. In addition, those SEFs that rely on a third party to transmit information to SDRs are further hindered by the embargo rule in their ability to make available to all market participants current market information.	Rule 43.3(b)(3)(i) "If there is a registered swap data repository for an asset class, a registered [SEF] . . . shall not disclose swap transaction and pricing data relating to publicly reportable swap transactions in such asset class, prior to the public dissemination of such data by a registered swap data repository unless: (A) Such disclosure is made no earlier than the transmittal of such data to a registered swap data repository for public dissemination; (B) Such disclosure is only made to market participants on such registered [SEF] . . . ; (C) Market participants are provided advance notice of such disclosure; and (D) Any such disclosure by the registered [SEF] . . . is non-discriminatory.	While the WMBAA appreciates the prior no-action relief provided in letter 13–68, the WMBAA believes that the problematic aspects of the requirement continue to persist and merit removing the requirement from the Part 43 rules. The CFTC should amend its regulations to permit a SEF post-initial trade work stream that promotes liquidity formation, including through SEF workups, while ensuring that the Commission's rules implementing the post-trade transparency requirement for public dissemination of swap data as soon as technologically practicable do not artificially restrict a SEF's ability to efficiently execute swap transactions. Further, the Commission should consider that, due to SDR "rounding" models and "capping" of large notional transactions, the information publicly disclosed is often not identical to specific trade-level information on the SEF.
CEA § 5h(f)(10) "RECORDKEEPING AND REPORTING.— (A) IN GENERAL.—A swap execution facility shall— (i) maintain records of all activities relating to the business of the facility, including a complete audit trail, in a form and manner acceptable to the Commission for a period of 5 years . . . ."	*SEF record-keeping Requirement* CFTC rules requiring SEFs to retain all records through the life of a swap and for at least 5 years following a swap's termination is an onerous and impracticable requirement for SEFs. Following the execution of a swap, a SEF is not necessarily made aware of a swap's termination. Accordingly, it is often impracticable for a SEF to definitively ascertain the period of time for which it must retain records for a swap and can result in significantly burdensome record-keeping costs.	Rule 45.2(c): "All records required to be kept pursuant to this section shall be retained with respect to each swap throughout the life of the swap and for a period of at least 5 years following the final termination of the swap."	Provide guidance to SEFs as to what materials must be retained for 5 years to satisfy the record-keeping obligation, which reduces the operational burden of maintaining all possible records, particularly those with minimal value from an audit trail perspective. For both cleared and uncleared swaps, revise the record-keeping requirement under rule 45.2 to permit SEFs to retain records with respect to each swap for a period of 5 years after execution.

APPENDIX B: WMBAA WHITE PAPER REGARDING POSITION LIMITS

White Paper: SEF Position Limits and Accountability Regimes are Neither Necessary Nor Appropriate

May 21, 2015

I. Introduction

The Wholesale Markets Brokers Association, Americas,[1] the leading industry organization representing the interdealer broker industry, provides this White Paper to explain why a position limits or position accountability regime for swap execution facilities ("SEFs") is neither necessary nor appropriate.

Section 5h of the Commodity Exchange Act ("CEA"), as added by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), includes a series of core principles for SEFs. In the 5 years since Dodd-Frank was adopted, the Commodity Futures Trading Commission ("CFTC" or "Commission") has worked to implement Section 5h of the CEA, adopting final regulations related to the core principles and other requirements for SEFs, including core principle number 6—position limits or accountability. An applicant SEF must comply with core principles to receive its permanent registration from the CFTC.

In practice, as explained in this White Paper, an overly prescriptive interpretation of this core principle would be unworkable, cost-intensive, and without any readily identifiable public policy benefits. While there have been calls for Congressional review of core principle 6,[2] the WMBAA believes, at this point, the Commission should consider a regulatory solution.

The approach described herein has been recently endorsed by a coalition of SEFs[3] and key industry groups.[4] The WMBAA supports such arguments, particularly that:

> The Commission should exempt SEFs from any requirement to enforce compliance with Federal limits or to establish SEF limits for contracts subject to Federal limits. As an alternative to setting position limits, SEFs should only be required to provide data to the Commission to assist it in monitoring compliance with Federal speculative position limits.[5]

The SEF marketplace is still in its formative years. The CFTC has not yet adopted a position limits regime for swaps. The Commission should tread carefully to avoid the imposition of a rigid, unworkable requirement that, without adequate cost-benefit analysis, may harm the development of these markets. Rather, as suggested by Chairman Timothy Massad, the CFTC should work to create "the foundation for the market to thrive" and "permit innovation, freedom and competition."[6]

II. Background

A. Position Limits, Position Accountability

The CFTC glossary defines a position limit as "[t]he maximum position, either net long or net short, in one commodity future (or option) or in all futures (or options) of one commodity combined that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by an exchange and/or by the CFTC." Fundamentally, a position limit caps the size of a position that a trader may hold or control for speculative purposes in a derivatives contract in a particular commodity. There are three elements of the regulatory framework for position limits: the levels of the limits, the exemptions from the limits (such as for hedging), and

[1] The WMBAA is an independent industry body representing the largest inter-dealer brokers operating in the North American wholesale markets across a broad range of financial products. The five founding members of the group are: BGC Partners; GFI Group; ICAP; Tradition; and Tullett Prebon. The WMBAA membership collectively employs approximately 4,000 people in the United States; not only in New York City, but in Stamford, Connecticut; Chicago, Illinois; Louisville, Kentucky; Jersey City, New Jersey; Raleigh, North Carolina; and Houston and Sugar Land, Texas. For more information, please see *www.wmbaa.org*.

[2] *See Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank,* CFTC Commissioner J. Christopher Giancarlo White Paper (Jan. 29, 2015), at 45, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf*.

[3] *See* SEF CCO Group Discussion Document Regarding SEF Core Principle 6—Position Limits and Position Accountability, May 21, 2015.

[4] *See* Letter from the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association to Ms. Melissa Jurgens, Secretary, CFTC (Feb. 10, 2014), available at *http://www.sifma.org/commentletters/2014/sifma-and-isda-submit-comments-to-the-cftc-on-position-limits-for-derivatives/*.

[5] *Id.* at 35.

[6] Remarks of CFTC Chairman Timothy Massad before the ISDA 30th Annual General Meeting (Apr. 23, 2015), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-17*.

the policy on aggregating accounts. While the CFTC has set certain commodity position limits, it has not yet established position limits for swaps.

By contrast, the CFTC glossary defines position accountability as "[a] rule adopted by an exchange *in lieu of* position limits requiring persons holding a certain number of outstanding contracts to report the nature of the position, trading strategy, and hedging information of the position to the exchange, upon request of the exchange." Position accountability does not, by definition, impose a hard limitation on traders' speculative derivatives positions in a commodity. Instead, position accountability provisions grant the exchange additional powers to protect its markets, including the ability to obtain additional information from the trader and to limit the size of a trader's position, when a trader's derivatives position exceeds a specified level.

B. SEFs and Position Limits

Core principle 6—codified as CEA Section 5h(f)(6)—mandates that a SEF "that is a trading facility" must "adopt for each of the contracts of the facility, as is necessary and appropriate, position limitations or position accountability for speculators." [7] Furthermore, "[f]or any contract that is subject to a position limitation established by the Commission pursuant to section 4a(a) of the [CEA], the [SEF] shall (i) set its position limitation at a level no higher than the Commission limitation; and (ii) monitor positions established on or through the [SEF] for compliance with the limit set by the Commission and the limit, if any, set by the [SEF]." [8]

The CFTC promulgated rule 37.600 by codifying the statutory language.[9] In the preamble to the final SEF rule, the CFTC noted that "[s]everal commenters stated that SEFs will have difficulty enforcing position limitations" because "SEFs will lack knowledge of a market participant's activity on other venues, and that will prevent a SEF from being able to calculate the true position of a market participant." [10] Furthermore, the CFTC describes the guidance and acceptable practices in appendix B to the part 37 rules as giving "reasonable discretion to comply with § 37.600." [11]

With respect to core principle 6, the guidance in Appendix B states that:

> For Required Transactions, a SEF may demonstrate compliance by setting and enforcing position limitations or position accountability levels only with respect to trading on the SEF's own market. For example, a SEF could satisfy the position accountability requirement by setting up a compliance program that continuously monitors the trading activity of its market participants and has procedures in place for remedying any violations of position levels.
>
> For Permitted Transactions, a SEF may demonstrate compliance by setting and enforcing position accountability levels or sending the Commission a list of Permitted Transactions traded on the SEF. Therefore, a SEF is not required to monitor its market participants' activity on other venues with respect to monitoring position limits.[12]

III. Role of Exchange-Set Position Limits and Position Accountability

In contrast to SEFs and position limits, the CFTC has historically adopted position limits for certain agricultural commodities and also has required exchanges, as part of their self-regulatory responsibilities, to adopt position limits or position accountability provisions in their market surveillance programs. Unlike the OTC swap market, futures contracts traded on exchange are owned and exclusively listed by an exchange. They are unique contracts that are unavailable anywhere else.

When the CFTC first promulgated speculative position limits, it noted that "the capacity of any contract to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, *i.e.,* the capacity of the market is not unlimited." [13] In the early 1990s, the CFTC adopted rules allowing exchanges to establish position accountability provisions, *in lieu of* position limits, for contracts that had been subject to exchange-set speculative position limits.

Exchange-based position limits have been adopted by designated contract markets ("DCMs"), or futures exchanges, and the position limits (or position accountability) provisions have been enforced through exchange rulebooks and their role as a self-regulatory organization conducting market surveillance programs. These protections

[7] Commodity Exchange Act ("CEA") § 5h(f)(6).

[8] *Id.*

[9] 17 CFR § 37.600.

[10] *Core Principles and Other Requirements for Swap Execution Facilities,* 78 FED. REG. 33,476, 33533 (June 4, 2013).

[11] *Id.*

[12] *Id.* at 33601.

[13] *Establishment of Speculative Position Limits,* 46 FED REG. 50938 (Oct. 16, 1981).

serve as a prophylactic tool to reduce the threats of market power and to ensure the integrity of and orderly trading in the derivatives market. Exchange-set position limit and position accountability rules help prevent traders from accumulating concentrated positions that could disrupt a market and cause artificial prices and disorderly trading, such as purposefully through the exercise of market power by the position holder (*e.g.,* actual or attempted manipulation) or to prevent one trader from negatively impacting market stability by liquidating too large of a position.

These rules obligate an exchange, as part of its market surveillance effort, to take account of large positions in their market either by imposing hard limits on traders' speculative positions or, in the case of position accountability, by providing exchanges with ways to address the market impact of large positions.

IV. SEFs Cannot Adopt an Exchange-Centric Position Limits or Accountability Regime

Exchange-based surveillance and position limit and position accountability regimes focus on market participants' concentrated speculative positions. CFTC staff has stated that "an acceptable market surveillance program should regularly collect and evaluate market data to determine whether markets are responding to the forces of supply and demand. An exchange also should have routine access to the positions and trading of its market participants." [14]

Exchanges can readily adopt and enforce position limits or position accountability provisions for futures and futures options because they have the means to carry out this oversight function. As mentioned before, exchanges own their contracts, the trading of which is only allowed on its respective exchange, and exchanges also own and operate the derivatives clearing organizations ("DCOs"), or direct trades to specified DCOs, that process and become the counterparty to each transaction executed on the exchange. Further, unlike futures on physical commodities for which the underlying products are in limited supply, the financial instruments underlying swaps subject to the trade execution mandate (interest rate and credit default swap indices) generally have very large or nearly inexhaustible deliverable supplies and a cash market sufficiently liquid to render swaps traded on those instruments highly unlikely to be susceptible to the threat of manipulation.

Exchanges also have "large trader reporting systems" [15] designed to obtain current information about traders' positions in their derivatives markets. Futures exchanges possess data showing the positions held by all reportable traders for each trading day based on reports from clearing members, futures commission merchants, and foreign brokers detailing close-of-business position data. Each futures exchange's "large trader reporting system" also provides information on the account's ownership and control and identifies futures and options traders who trade for the account. By assigning unique identification numbers to each trader, futures exchanges can aggregate traders' positions across different accounts at multiple clearing members to include the positions of all related affiliates.

By contrast, SEFs are trading platforms that merely foster liquidity for swap execution. They do not have any ownership or proprietary control over the products bought and sold on their platforms. SEFs do not hold customer funds. They do not guarantee performance by counterparties. And, most importantly as discussed below, SEFs do not possess information about a trader's position in any given swap.

A. Position Limits

Under Section 4a of the CEA, the Commission is required to establish position limits only after it determines that such position limits are necessary and appropriate. To date, the CFTC has not made that determination for financial swaps and, as a result, has not established position limits for these products. However, even if such limits were put in place, SEFs are limited in their ability to monitor for position limits violations. SEFs can only monitor market activity for those transactions that take place on its trading system or facility. A SEF only has information about trading activity on its facility and does not possess, and has limited means to obtain, information about its participants' positions in swaps from activity on other venues. There are currently 24 applicant SEFs, making it impossible for any one SEF to know how its participants may transact on the 23 other platforms.

In practice, while a participant may enter into a transaction of size on one SEF, the SEF has no way of knowing if the participant has offset (or increased) its posi-

[14] *See* CFTC Division of Market Oversight, *Rule Enforcement Review of ICE Futures U.S.* (July 22, 2014), at 4, available at *http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/icemarksurrer072214.pdf.*

[15] *See* Large Trader Reporting Program, *http://www.cftc.gov/IndustryOversight/MarketSurveillance/LargeTraderReportingProgram/ltrp*.

tion in the swap through trading on other platforms. A swap that is listed and traded on one SEF may, unbeknownst to that SEF, be traded on other SEFs, DCMs, or bilaterally between counterparties away from any SEF or DCM. As a result, SEFs and DCMs listing swaps do not possess information about a trader's position in any given swap.

Position limit information is more appropriately collected by other segments of the swap market, including market participants, DCOs, and swap data repositories ("SDRs"). However, even a DCO or SDR would only have information about traders' cleared positions or reported positions at its individual organization. Only the participants themselves would have information about their overall cleared and uncleared swaps position in a market.

As a result, it is the WMBAA's view that only the CFTC (or a self-regulatory body possessing position information about swap market participants from SDR and DCO reports) can effectively police the swaps market to detect position limit violations and have the enforcement tools to take meaningful action to deal with violations. Imposing a position-based requirement on SEFs would be ineffective and would incur significant redundancies, potential miscounting or double counting of trades, and significant impediments related to data standards among the 24 applicant SEFs. In addition, if all of the SEFs set their individual position limit thresholds equal to the not-yet adopted CFTC's limits, this regime could encourage "gaming" by market participants who could spread their activity across SEFs to avoid triggering a "limit check" by any one SEF.

B. Position Accountability

As the National Futures Association ("NFA") recently concluded after conducting a data-driven analysis, position accountability levels will do little to "reduce the potential threat of market manipulation or congestion, the stated goal of the [SEF core principles]." [16]

The WMBAA believes the concept of a SEF position accountability regime is flawed. Most importantly, as discussed above, position accountability is meaningful as a market surveillance tool only in the context of centralized marketplaces such as exchanges, which is due to the fact that they own the products traded and possess information about traders' actual positions in the relevant derivatives marketplace. Because SEFs do not own products, and therefore do not possess the same position information, it is not necessary or appropriate for SEFs to adopt position accountability.

Moreover, recognizing the impracticability of SEFs adopting position limits or position accountability regimes, there have been suggestions that SEFs adopt, in effect, "trading accountability" provisions as a means of complying with core principle 6 (*i.e.,* SEFs would institute enhanced oversight of and data gathering from a trader based solely on trading activity or the size of transactions). This suggestion is problematic for two reasons. First, the CEA, as amended by Dodd-Frank, does not contemplate a trading activity-based accountability regime, but rather contemplates a position management-focused component. Furthermore, there is no clear metric available for SEFs to conduct a position accountability framework. As identified by the NFA in its recent report, "[n]otional transaction size alone is a misleading measure of risk." [17] The NFA further concluded that "the swap market might not lend itself to notional transaction size accountability levels at the SEF level." [18]

V. Conclusions

The WMBAA has always supported efforts to promote stability, efficiency, transparency, and competition in furtherance of Dodd-Frank's goal to promote the trading of swaps on SEFs. This includes taking steps to minimize threats posed to swap markets, including market manipulation from concentrated positions in a certain swap.

For the reasons previously stated, however, the WMBAA does not believe that a SEF-based position limit or position accountability regime is necessary or appropriate to meet the purposes set forth in Dodd-Frank.

The WMBAA members and other competitor SEFs want to be part of the solution. These venues are bound by a series of core principles to ensure fair, vibrant markets. They provide daily CFTC Part 16 lists of transactions to the CFTC, and they transmit full trade details to SDRs pursuant to their Part 43 and Part 45 confirmation and reporting obligations. These data transmissions provide the CFTC with the ability to combine data across SEFs to monitor large positions and address position

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[16] NFA Swap Accountability Levels Study (Apr. 2, 2015).
[17] *Id.*
[18] *Id.*

limit violations should the CFTC determine to establish position limits or position accountability provisions for swap contracts.

In considering ways to monitor swap markets for excessive positions, only the CFTC, or a CFTC designated neutral third-party self-regulatory organization would be in the position to collect, maintain, and synthesize the data to perform this function in an efficient, cost-sensitive manner. SEFs operating within the unique framework of the execution-only, competitive SEF landscape, in contrast to the vertically-integrated futures market structure, are ill-suited to establish a position limits or accountability regime.

The CHAIRMAN. Thank you, Mr. Merkel.

Mr. Berger.

STATEMENT OF STEPHEN JOHN BERGER, DIRECTOR, GOVERNMENT AND REGULATORY POLICY, CITADEL, LLC, NEW YORK, NY; ON BEHALF OF MANAGED FUNDS ASSOCIATION

Mr. BERGER. Thank you. Chairman Scott, Ranking Member Scott, Members of the Subcommittee, my name is Stephen Berger, and I am the Director of Government and Regulatory Policy at Citadel.

Citadel is a leading global financial institution that manages hedge funds and provides capital market services.

I am here today on behalf of the Managed Funds Association and its members, and I am pleased to provide testimony as part of the Committee's review of the impact of the G20 clearing and trade execution requirements.

MFA represents the majority of the world's largest hedge funds, and is the primary advocate for sound business practices and thoughtful regulation of the industry. MFA continues to support reforms to the OTC derivatives markets, including central clearing and trading on open, transparent venues. These reforms have reduced systemic risk, increased protections for investors, promoted competition, and strengthened our nation's financial markets.

I would like to highlight a few recommendations from my written statement that I believe would further help realize these benefits. With respect to clearing, MFA has been a consistent advocate for the central clearing of OTC derivatives transactions. Clearing replaces the interconnected web of counterparty exposures with a safer system where all participants face a well-regulated clearinghouse. This reduces systemic risk and enhances the stability and efficiency of our markets. Clearing also benefits investors by mitigating counterparty credit risk, increasing transparency, and facilitating greater choice of trading counterparties and platforms.

In the U.S., clearing has been successfully implemented for a significant portion of the interest rate swap and index credit default swap markets. In the U.S. today, approximately 75 percent of these swap transactions are cleared, compared to only 16 percent in 2007. Notably, over the past several years, investors have successfully cleared hundreds of trillions of dollars worth of swap transactions. Nevertheless, there are two areas where further progress should be made.

First, customer clearing in the U.S. must remain affordable and robust. MFA is concerned that the Basel Committee's leverage framework will needlessly, but significantly, increase the cost of clearing for customers by failing to recognize the exposure-reducing effects of segregated customer initial margin. The Basel leverage ratio should be modified so that it provides an offset for customer initial margin, posted to a clearinghouse or segregated under U.S. rules.

Second, further work is required from the CFTC and the SEC to implement a viable portfolio margining regime for the CDS market. The Dodd-Frank Act specifically sought to promote portfolio margining, which allows customers to realize margin efficiencies by recognizing offsetting risks within their portfolios. However, the interim framework that exists today falls short of meeting this goal, and has adversely impacted customer clearing.

Looking forward, MFA supports further efforts to expand central clearing to interest rate swaps denominated in all of the G10 currencies, and to harmonize these requirements globally. While the U.S. was the first to implement central clearing, many other jurisdictions have made substantial progress in their own implementation. Notably, Europe is beginning to phase in central clearing this year, and the scope of the European clearing obligation is nearly identical to that in the U.S.

Turning now to the implementation of the G20 trade execution requirements. MFA continues to support transitioning the trading of standardized liquid cleared swaps and to swap execution facilities that provide impartial access and facilitate straight-through processing to clearing. This transition promises to benefit investors by increasing market efficiency, competition, transparency, and liquidity. Recent research by the Bank of England concluded that the implementation of reforms in the U.S. interest rate swaps market yielded significant improvements in pricing and liquidity.

Although the SEF market continues to evolve, a two-tier structure unfortunately persists, preventing investors from fully participating in all of the various SEF liquidity pools. This two-tier market, which reserves certain liquidity pools for dealers only, and confines investors to others, hinders choice and competition, and frustrates the core principle of impartial access. A key roadblock perpetuating the two-tier SEF marketplace is the practice of post-trade name give-up where the identities of counterparties to otherwise anonymous trades are revealed or given up post-trade. This is a legacy practice that no longer serves any legitimate purpose for cleared swaps where counterparties face clearinghouses and not each other. However, by systematically revealing private trading information, name give-up deters investors from participating on those SEFs that employ it, namely, the historically dealer-to-dealer SEFs. We believe regulatory action is needed to remove this impediment to investors and partial access to all SEFs.

We appreciate the Committee's oversight of derivatives clearing and trading, and I thank you for the opportunity to speak here today. I would be happy to answer any questions.

[The prepared statement of Mr. Berger follows:]

PREPARED STATEMENT OF STEPHEN JOHN BERGER, DIRECTOR, GOVERNMENT AND REGULATORY POLICY, CITADEL, LLC, NEW YORK, NY; ON BEHALF OF MANAGED FUNDS ASSOCIATION

Chairman Scott, Ranking Member Scott, my name is Stephen Berger and I am the Director, Government & Regulatory Policy, of Citadel LLC. Citadel is a global financial firm built around world-class talent, sound risk management, and innovative market-leading technology. For more than a quarter of a century, Citadel's hedge funds and capital markets platforms have delivered meaningful and measurable results to top-tier investors and clients around the world. Citadel operates in all major asset classes and financial markets, with offices in the world's leading financial centers, including Chicago, New York, San Francisco, Boston, London, Hong Kong, and Shanghai.

I am here today to speak on behalf of Managed Funds Association ("**MFA**") and its members regarding the impact of the G20 clearing and trade execution requirements for OTC derivatives. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices for hedge funds, funds of funds, managed futures funds, and service providers. MFA's members manage a substantial portion of the approximately $3 trillion invested in hedge funds around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated investors and play an important role in our financial system. They are active participants in the commodity and securities markets, including over-the-counter ("**OTC**") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Hedge fund managers are fiduciaries that invest funds on behalf of institutional and high-net worth investors. Our members' skills help their customers plan for retirement, honor pension obligations, and fund scholarships, among other important goals.

As part of their asset management strategies, MFA members are active participants in the derivatives markets, and have consistently supported reforms to the OTC derivatives markets in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") that mitigate systemic risk, increase transparency, and promote an open, competitive, and level playing field. We welcomed the market's transition to central clearing for liquid, standardized swaps that occurred over the course of 2013, and actively engaged in the market's evolution of trading liquid, standardized, cleared swaps on registered swap execution facilities ("**SEFs**") that commenced in 2014.

As a result, MFA has a strong interest in the successful implementation of central clearing and organized trade execution in the OTC derivatives markets, which further the goals of the G20 and the Dodd-Frank Act to mitigate systemic risk and provide open and accessible markets for investors. In this respect, we believe there are several additional steps that the Commodity Futures Trading Commission ("**CFTC**") should take to promote further central clearing and the market's transition to trading on SEFs. These steps include: (1) expanding mandatory central clearing of interest rate swaps ("**IRS**") to include swaps denominated in all the G10 currencies; (2) further working with the Securities and Exchange Commission ("**SEC**") to develop a viable portfolio margining regime for cleared credit default swaps ("**CDS**") as mandated by Congress in the Dodd-Frank Act, (3) codifying existing CFTC staff guidance addressing impartial access to SEFs; (4) clearly prohibiting post-trade name disclosure by SEFs that offer anonymous execution of cleared swaps; and (5) making certain other targeted amendments to its final SEF rules to improve the overall trading regime. In addition, we believe the Basel Committee on Banking Supervision ("**Basel Committee**") should modify its treatment of segregated initial margin for centrally cleared derivatives for purposes of the Basel III leverage ratio to ensure that central clearing remains affordable for customers.

On behalf of MFA, I appreciate the Committee's review and oversight of the impact of the G20 clearing and trade execution requirements. MFA has consistently provided constructive comments and suggestions to regulators to help implement these mandates. We believe our comments are consistent with the Committee's public policy goals and will further enhance the benefits of OTC derivatives markets. As active participants in the U.S. markets for OTC derivatives, we would like to work with the G20 countries, Congress, the Committee, the CFTC, and all other interested parties to further the optimal implementation of the clearing and trade execution rules, which will reduce systemic risk, ensure affordable and impartial access to our financial markets, and strengthen our nation's economy.

Central Clearing and Its U.S. Implementation

MFA has consistently supported policymakers' efforts to reduce systemic risk in the derivatives markets by transitioning standardized and liquid OTC derivative contracts into central clearing. The implementation of central clearing was a central goal of the 2009 G20 commitments and the U.S. has been at the forefront of the move to central clearing.

MFA believes that central clearing has reduced systemic risk by eliminating the complex, interconnected web of counterparty exposures and replacing it with a safer system where all counterparties face a single well-regulated central counterparty ("**CCP**"). Today, the prominent CCPs serving the U.S. market are operated by CME Group ("**CME**"), the Intercontinental Exchange, Inc. ("**ICE**"), and LCH.Clearnet ("**LCH**"). While not all derivatives products have sufficient liquidity to merit being made subject to the mandatory clearing requirement, in the U.S., we have seen the successful implementation of central clearing for a significant portion of the IRS and index CDS markets.

The progress in implementing central clearing in the U.S. has been impressive. According to CFTC Chairman Timothy Massad, approximately 75% of outstanding U.S. swap transactions (measured by notional value) are being cleared, as compared to only 16% in 2007.[1] In particular, the progress in implementing central clearing for end-users and other customers of OTC derivatives has been notable. LCH has approximately $21.3 trillion notional of customer IRS transactions outstanding.[2] At CME, open interest in IRS is approximately $17.7[3] trillion notional, and predominantly driven by customers. Finally, ICE has cleared approximately $20.8 trillion notional of index CDS for customers.[4]

As a result, in MFA's view, the implementation of central clearing in the U.S., thus far, has been successful and made our financial system much safer. In particular, we believe that central clearing has greatly benefitted the market by:

- Mitigating systemic risk and reducing the risk of contagion;
- Providing a mechanism for the orderly unwind of the portfolio of a defaulting market participant that is also designed to protect non-defaulting customers from losses;
- Promoting discipline with respect to margin and collateral practices;
- Improving market transparency;
- Increasing competition among potential trading counterparties and liquidity providers; and
- Supporting the migration of trading onto more open, transparent, trading venues.

In addition, the CFTC has enhanced the integrity of the execution-to-clearing workflow by implementing straight-through processing ("**STP**") requirements. The CFTC's STP rules require clearing members to conduct pre-execution credit checks in order to pre-empt post-execution rejections of trades submitted for clearing, and to establish strict timeframes around how quickly an executed trade must be submitted to, and accepted or rejected by, a CCP. As a result, these STP requirements strengthen market resilience, enhance risk management, protect investors by reducing counterparty risk, and promote overall market transparency and efficiency. Importantly, the CFTC's STP rules established a standard that has now been adopted by the European Union ("**EU**") in the context of implementing the Markets in Financial Instruments Directive ("**MiFID II**").

While not all of the G20 countries have implemented mandatory clearing requirements, we appreciate the positive steps taken by many countries to achieve harmonization and implementation of central clearing on a global basis. For example, mandatory central clearing of certain OTC derivatives will begin in the EU later this month. In addition, central clearing has already begun in Australia and Mexico, and is expected to begin soon in other countries, including Canada, Hong Kong, Singapore, and Switzerland. Notably, in light of these global developments, the CFTC has recently proposed to expand the central clearing requirement in the U.S. to harmonize with these foreign jurisdictions.[5] Last, we applaud the CFTC and the

[1] Remarks of Timothy G. Massad before the Swaps Execution Facilities Conference (SEFCON V), November 12, 2014, available at: *http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-4*.

[2] *See* LCH Daily Volumes—SwapClear Global, available at: *http://www.lch.com/en/asset-classes/otc-interest-rate-derivatives/volumes/daily-volumes-swapclear-global*.

[3] *See* CME Open Volume Tracker, available at: *http://www.cmegroup.com/education/cme-volume-oi-records.html*.

[4] *See https://www.theice.com/clear-credit*.

[5] *See* CFTC notice of proposed rulemaking on "Clearing Requirement Determination under Section 2(h) of the CEA for Interest Rate Swaps" ("**CFTC Additional IRS Proposal**"), available at: *http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister060916.pdf*.

European Commission for reaching an agreement on a common approach to the regulation of CCPs earlier this year.[6] This agreement will help to ensure that the G20 goal of global, harmonized OTC derivatives regulation is fully achieved.

Expanding Central Clearing of IRS to Other Currencies

Consistent with the CFTC Additional IRS Proposal, MFA supports the expansion of central clearing to IRS denominated in additional currencies.

Under current CFTC rules, the clearing requirement applies only to IRS denominated in the G4 currencies, which include U.S. Dollars, Euros, Japanese Yen, and British Pound Sterling. MFA believes that the clearing mandate should be expanded to include IRS denominated in all of the G10 currencies[7] because those additional IRS classes are traded in significant volumes globally.

The CFTC Additional IRS Proposal to expand the clearing mandate would apply to IRS denominated in Australian dollars, Swiss francs, Canadian dollars, Mexican pesos, Polish zloty, Swedish Krona, Norwegian Krone, Hong Kong dollars, and Singapore dollars. The European Commission has also recently adopted final regulatory technical standards that expand the EU clearing mandate to IRS denominated in Polish zloty, Swedish Krona, and Norwegian Krone.[8] The CME and LCH already clear IRS denominated in these currencies and market participants already voluntarily clear a significant amount of these instruments.

Consistent with the goal of reducing systemic risk through the international convergence of central clearing, MFA believes that transitioning IRS denominated in the G10 currencies to the clearing requirement is appropriate and timely.

Ensuring the Affordability of Customer Clearing

Customers are a vital part of the derivatives markets and have been critical to the success of central clearing in the U.S. While some clearing of swaps between dealers existed prior to enactment of the Dodd-Frank Act, artificial barriers to entry prevented customers from similarly participating in the cleared swaps market. Implementation of the central clearing requirement eliminated many of those artificial barriers and resulted in substantial customer clearing.

However, at present, swaps customers exclusively access CCPs indirectly through clearing members, rather than becoming direct members of CCPs, for a variety of reasons, both financial and operational. MFA expects the demand for clearing services to increase as regulators in different jurisdictions fully implement their respective mandatory clearing initiatives. As a result, it is critical that customer clearing services remain available at an affordable price to ensure that customers have fair and equal access to CCPs.

MFA has strong concerns about the Basel Committee's treatment of segregated initial margin for centrally cleared derivatives exposure under the Basel III leverage ratio ("**Leverage Ratio**") because it threatens the ability of customers to use centrally cleared derivatives and could limit the ability of end-users to hedge their risks.

CCPs' risk management methodologies are predicated on the collection of initial margin and variation margin from clearing members and customers in order to collateralize potential exposure. In addition, direct clearing members guarantee payment of their customers' obligations to the CCP. Because the initial margin is the customer's money,[9] CFTC rules require clearing members to segregate customer funds from the clearing member's own assets.

While the Basel Committee's framework captures a clearing member's guarantee to the CCP as an off-balance sheet exposure, the Leverage Ratio fails to provide an offset that recognizes the exposure-reducing effect of customers' segregated initial margin. According to the Basel Committee, the reason for the lack of an offset for customer initial margin is that segregated customer initial margin not only offsets

[6] *See The United States Commodity Futures Trading Commission and the European Commission: Common approach for transatlantic CCPs,* 10 February 2016, available at: *http://www.cftc.gov/idc/groups/public/@newsroom/documents/speechandtestimony/eu_cftcstatement.pdf.*

[7] The G10 currencies are the U.S. Dollar (USD), Euro (EUR), Japanese Yen (JPY), British Pound (GBP), Swiss Franc (CHF), Australian Dollar (AUD), New Zealand Dollar (NZD), Canadian Dollar (CAD), Swedish Krona (SEK), and Norwegian Krone (NOK).

[8] *See* European Commission Delegated Regulation (EU) . . ./. . . of 10.6.2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation, 10 June 2016, available at: *http://ec.europa.eu/finance/financial-markets/docs/derivatives/160610-delegated-regulation_en.pdf.*

[9] Under CFTC rules, a clearing member must separately account for, and segregate as belonging to the customer, all money, securities and property it receives from a customer as margin. *See* 17 CFR §§ 1.20–1.30; 17 CFR §§ 22.2–22.7; *see also* CFTC Chairman Timothy Massad, Testimony before the U.S. House Committee on Agriculture (Feb. 12, 2015).

exposures, but also can be used by the clearing member for further leverage. In the U.S., segregation rules severely restrict the ability of initial margin to be held in anything other than extremely low-risk and extremely liquid assets, assuring that it is always available to absorb losses ahead of the bank.[10] Moreover, the substantial majority of segregated initial margin is posted to the CCP, and therefore, is entirely outside the control of the clearing member.[11]

The Leverage Ratio's failure to recognize the purpose of segregated initial margin is a threat to the use of cleared derivatives by customers. Because of the lack of offset, clearing members will incur large Leverage Ratio exposures, which will likely raise prices for customer clearing significantly. The Leverage Ratio, as currently structured, is estimated to increase significantly the cost of using cleared derivatives.[12] This substantial cost increase may cause customers to reduce their hedging activities to levels that are inadequate to manage their risk, which could result in price increases and volatility for food, gasoline, and other consumer goods.

Therefore, to ensure the continued affordability and robustness of customer clearing in the U.S., we respectfully request that the Committee encourage the Basel Committee to modify the Leverage Ratio by providing an offset for clearing members to the extent that customer initial margin is posted to the CCP, or is segregated under the U.S. regulatory regime.

Ensuring a Viable Portfolio Margining Regime

The Dodd-Frank Act divided jurisdiction over OTC derivatives between the CFTC and the SEC. For CDS, the CFTC has jurisdiction over most CDS indices, while the SEC has jurisdiction over single-name CDS. The CFTC has mandated clearing of certain CDS indices, but the SEC has not yet issued a clearing mandate for single-name CDS. However, a number of MFA members would like to voluntarily clear single-name CDS in order to take advantage of the portfolio margining benefits arising from offsetting positions in cleared index CDS and single-name CDS.

Portfolio margining simply means recognizing the offsetting positions within a cleared OTC derivatives portfolio, resulting in margin efficiencies. Section 713 of the Dodd-Frank Act specifically encouraged the SEC and the CFTC to work together to implement a regulatory framework that facilitates portfolio margining.

ICE has an offering that enables market participants to clear both index CDS and single-name CDS in a CFTC-regulated account under the Commodity Exchange Act, as amended ("**CEA**"). In 2011, both agencies issued orders approving ICE's portfolio margining regime for dealers' proprietary CDS positions. Over a year later, both agencies approved ICE's portfolio margining regime for customers. However, the SEC's approval order imposed a number of conditions on ICE and clearing member firms seeking to offer a CDS customer portfolio margining program.

Notably, each clearing member firm is required to establish its own margin methodology that is different from the margin methodology of the CCP and must submit its margin methodology to the SEC for review and approval. The requirement for each clearing member to have its own margin methodology undermines one of the fundamental benefits of central clearing, which is the ability for all market participants to rely on the same, fully vetted and approved margin methodology maintained by the CCP. In addition, it reduces transparency for clearing customers, as it is difficult to evaluate and compare the different margin methodologies separately established by each clearing member.

In our view, the requirements imposed by the SEC have delayed voluntary buy-side clearing of single-name CDS, with resulting adverse effects on trading volume and liquidity. We urge the SEC to use the CCP's vetted and approved margin methodology as the baseline, with clearing members able to collect additional margin as they deem appropriate according to their assessment of a clearing customer's credit

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[10] In the United States, segregated margin cannot be reinvested except for investments in low-risk and highly liquid assets, such as U.S. government securities, managed "with the objectives of preserving principal and maintaining liquidity". See 17 CFR § 1.25(b).

[11] Applicable U.S. margin and CCP regulations result in a significant majority of margin being passed onto the CCP. Although margin rules vary across jurisdictions outside of the U.S., non-U.S. margin frameworks for centrally cleared derivatives generally result in a substantial portion of margin held at the CCP rather than the clearing member.

[12] The Commodity Markets Council ("**CMC**") estimates that the Leverage Ratio, as currently structured, would increase the cost of using cleared derivatives by more than five times current levels. This estimate is based on conversations by CMC members with clearing members. The increase in costs would be due to increased fees for cleared derivatives. CMC and MFA members also anticipate incurring business costs due to their diminished ability to hedge commercial and financial risks. *See also,* Fiona Maxwell, *Non-bank FCMs unlikely to fill OTC gap,* RISK, Oct. 7, 2015, available at: *http://www.risk.net/risk-magazine/news/2429225/non-bank-fcms-unlikely-to-fill-otc-gap#*.

risk. This approach will enable a viable portfolio margining regime for cleared CDS as mandated by Congress in the Dodd-Frank Act.

Swap Execution Facilities and the Trade Execution Requirement

MFA continues to support the Dodd-Frank Act's goal of transitioning the trading of standardized, liquid, cleared swaps onto SEFs that provide open and impartial access and enable the emergence of an "all-to-all" market (where multiple market participants are able to meet and transact). MFA believes the CFTC SEF framework benefits the swaps market and its participants by increasing market efficiency, competition, transparency and liquidity. In fact, according to recent Bank of England research, the implementation of the clearing and trading reforms in the U.S. interest rate swaps market has already yielded significant improvements in pricing and liquidity, with market participants saving as much as $20–$40 million per day, of which $7–$13 million is being saved by market end-users alone per day.[13]

While the SEF market continues to evolve, MFA believes the current SEF regime can be enhanced by the CFTC taking certain additional steps to address the current two-tier market structure and the legacy practice of post-trade name disclosure on SEFs that offer anonymous execution of cleared swaps.

Two-Tier Market

Nearly 3 years after the launch of the SEF marketplace, MFA is concerned that the swaps market remains bifurcated between "dealer-to-dealer" or inter-dealer broker ("**IDB**") SEFs that exclude most buy-side firms and "dealer-to-customer" (or "**D2C**") SEFs.

- IDB SEFs: In one tier, the IDB SEFs offer central limit order books ("**CLOBs**") and voice-brokered request-for-quote ("**RFQ**") models, among others, with trading on an anonymous basis but the identities of counterparties revealed post-trade. While IDB SEFs may have onboarded a number of buy-side firms, there is no meaningful buy-side trade execution and participation on IDB SEFs.
- D2C SEFs: In the second tier, D2C SEFs offer electronic RFQ systems, which effectively require the buy-side to trade with dealers by requesting quotes on a name-disclosed basis. Although D2C SEFs provide order books, there is more limited liquidity available. Nearly all SEF trading volume by the buy-side occurs on two dominant D2C SEFs via name-disclosed RFQ.

This two-tier market structure prevents the buy-side from accessing important pools of liquidity for cleared swaps, including the liquid order books. This market structure also confines the buy-side to a "price-taker" role, rather than providing the opportunity to become a "price-maker" as well.

MFA believes that the persistence of the two-tier swaps trading market structure "*status quo*" is contrary to Congress's reform goals. It is inconsistent with the Dodd-Frank Act's express impartial access requirement for SEFs.[14] In our view, the *status quo* needs to change to improve competition and market liquidity.

Impartial access has contributed to the health and vitality of several other significant markets (such as equities and futures markets, where any participant can "make" or "take" prices). By contrast, the two-tier swaps market structure perpetuates traditional dealers' control of liquidity and protects their role as exclusive "price makers". It also limits the manner and extent to which buy-side participants may interact in the swaps market. Such structural limitations on liquidity provision and risk transfer may increase the likelihood of market volatility and instability over the long term. The willingness and capacity of traditional dealers to allocate balance sheet (*i.e.,* for dealers to use their own funds) to swaps market-making activities appears to be diminishing in certain respects. This trend will likely continue over time as traditional dealers continue to restructure their businesses post-financial crisis and adapt to new capital, leverage, and liquidity requirements under Basel III and similar rules. Without swaps market reforms that facilitate impartial access to all SEFs and encourage alternative forms of price formation and liquidity provision and greater diversity of participation (among participants and modes of

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[13] *See* Staff Working Paper No. 580 "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act", Bank of England (January 2016), available at: *http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf.*

[14] Pub. L. 111–203, 124 Stat. 1376 (2010). Section 733 of the Dodd-Frank Act amends the CEA to require, in pertinent part, that SEFs both establish and enforce participation rules and have the capacity to enforce those rules, including the means to provide market participants with impartial access to the market. *See also* CFTC rule 37.202 in the CFTC final rule on "Core Principles and Other Requirements for Swap Execution Facilities", 78 *Fed. Reg.* 33476, 33587 (June 4, 2013), available at: *https://www.gpo.gov/fdsys/pkg/FR-2013-06-04/pdf/2013-12242.pdf.*

interaction), MFA fears that the U.S. swaps market could risk greater volatility and dislocation in times of market stress.

Congress designed the swaps market reforms under Title VII of the Dodd-Frank Act to produce a more competitive and transparent swaps market structure. Based on the examples set by other significant trading markets noted above, MFA believes that true impartial access, once implemented and enforced, will provide a stronger foundation for U.S. swaps market liquidity and enhance price transparency in the U.S. swaps market. This outcome will contribute beneficial effects to the nation's economy.

Post-Trade Name Give-Up

A key mechanism suppressing buy-side trading on IDB SEFs and directly contributing to the current two-tier market structure in the U.S. is the legacy practice of post-trade name disclosure (or "give up"). We believe that a SEF that imposes access limitations that deter buy-side participation in its market contravenes the impartial access requirement. Even though otherwise eligible buy-side participants have access to all SEFs in theory, the loss of anonymity caused by the continuation of post-trade name disclosure is a strong disincentive to buy-side participation in IDB SEFs in practice.

The practice of post-trade name give-up originates in anonymous markets for *uncleared* swaps. Participants in the uncleared swaps market reasonably need to limit the firms with which they may trade in order to manage counterparty credit risk. Further, to record each new bilateral swap with a given counterparty on their books, participants need to learn the identity of the counterparty with whom they were matched. Thus, post-trade name disclosure and the attendant limitations on interactions among market participants are justified in the uncleared swaps markets where counterparties have credit exposure to each other.

While the practice may have served a purpose prior to the implementation of the current swaps trading and clearing regime, today it needlessly reveals the identities of counterparties to otherwise anonymous cleared trades. In the early days of the cleared swaps market, counterparties used post-trade name disclosure to coordinate submission of trades to clearing after trade execution. However, the successful implementation of STP for SEF-executed trades, including the pre-trade credit check process, has eliminated any need to use post-trade name disclosure to either manage counterparty credit risk or facilitate clearing submission. Post-trade name disclosure nevertheless continues to occur as a routine practice on IDB SEFs.

MFA strongly believes that for swaps that are anonymously executed and then immediately cleared, there is no legitimate reason for a party to the cleared swap to know the identity of its original executing counterparty. Once the CCP accepts the trade for clearing, the trade exists only as a cleared trade. The obligations to perform on a cleared trade run only between the CCP and the party to the trade (and, where applicable, its agent clearing member). In a cleared trade, the CCP is the sole counterparty to each of the original transacting parties, and, again, the original transacting parties have no rights or responsibilities with respect to each other.

As a result, we firmly believe that the legacy practice of post-trade name disclosure no longer has a legitimate commercial, operational, credit or legal justification in cleared swap markets where transacting parties face the clearinghouse and are not exposed to each other's credit risk following trade execution.

Adverse Effects of Post-Trade Name Disclosure in the Current Swaps Trading and Clearing Regime

Among its other adverse effects, post-trade name disclosure is a source of random and uncontrolled "information leakage" of private information on SEFs that offer anonymous execution of cleared swaps. It deters buy-side firms from trading on IDB SEFs because it reveals a firm's private trading positions and trading strategies to competitors or dealers. By doing so, post-trade name disclosure appears inconsistent with CFTC rules prohibiting access to private trading information. In contrast, when a buy-side firm discloses its identity and trading interests in the RFQ market, a buy-side firm has control of the associated "information leakage" because it can choose to whom it sends an RFQ.

Prohibiting post-trade name disclosure on SEFs would protect the privacy of an original counterparty's identifying information as required by CFTC rule 49.17(f)(2), as amended. In response to concerns that MFA and other market participants raised that the identity of counterparties to anonymously executed swap trades could be inadvertently revealed post-trade by a swap data repository ("**SDR**"), the CFTC voted unanimously to adopt an interim final rule that amended the scope of CFTC rule 49.17(f)(2) by making explicit the limitation on counterparty access to data and information related to an anonymously executed, cleared swap that applies to SDRs by virtue of the privacy requirements of CEA section 21(c)(6). Without further regulatory action to prohibit the practice of post-trade name disclosure, a counterparty can continue to obtain the identities of its original transacting parties from the SEF or from the affirmation hub that processes the SEF's trades, even though the SDR is required to protect the privacy of such information. Because section 21(c)(6) of the CEA mandates the privacy requirement imposed under CFTC rule 49.17(f)(2), MFA believes that allowing a SEF to facilitate or permit post-trade name disclosure frustrates clear Congressional intent.

Post-trade name disclosure also perpetuates informational and trading advantages for traditional dealers that benefit from their ability to access and achieve full visibility into both the inter-dealer and dealer-to-customer markets. Buy-side firms do not have true impartial access to the IDB SEFs that offer anonymous execution through CLOBs and other execution models due to the continued practice of post-trade name disclosure. MFA believes that the continuation of this practice creates an uneven playing field and impairs competition, as it reduces pre-trade price transparency for otherwise qualified buy-side market participants and restricts their ability to trade certain swap products anonymously.

Due to the nature of liquidity in swap markets, it is unlikely that the market will resolve this artificial barrier to buy-side participation on IDB SEFs on its own. Post-trade name disclosure appears inconsistent with the letter and intent of the Dodd-Frank Act's swaps market reforms and CFTC rules, and in our view the CFTC has ample authority to prohibit this practice. MFA believes that regulatory action to prohibit post-trade name disclosure would increase the volume of buy-side trading on SEFs as it would attract more users and thus more trading volume to these platforms, and allow more flexible and efficient execution of both outright swaps and package transactions.

While some argue that market dynamics will address post-trade name disclosure and its adverse effects, we respectfully disagree. Commercial and competitive dynamics make it difficult for any one IDB SEF to disable post-trade name disclosure unilaterally, as traditional dealers that opposed such a change might easily shift their trading to other IDB SEFs. This is a classic case where only the regulator can readily bring competition and fairness to the market by eliminating post-trade name disclosure on any SEF that offers anonymous execution of cleared swaps. Doing so will increase the diversity, breadth, and depth of liquidity on SEFs and thereby reduce the potential for market volatility and disruptions.

MFA is aware of several arguments to preserve the practice of post-trade name disclosure on IDB SEFs. We summarize below our counter-arguments based on the extensive swaps trading experience of many MFA members.

- *Post-Trade Name Disclosure is Not Necessary to Deter "Gaming".* Some have argued that the practice of post-trade name disclosure should be preserved to prevent buy-side firms from "gaming" the market. Proponents of this view claim that buy-side firms could post a low resting bid (or high resting offer) in an anonymous CLOB, and then solicit a dealer through an RFQ to motivate the dealer to lower its price in reliance upon the price level posted in the CLOB. This theoretical risk exists in any market that employs both anonymous and disclosed trading protocols and historically, has not risen to a level of serious concern. The Treasury securities and foreign exchange markets, for example, have operated for years with both anonymous and disclosed execution channels, and participants have been able to trade across both without concerns of gaming. Nothing about the swaps market necessitates a different policing paradigm from other markets. Further, SEF CLOBs require market participants to post firm resting bids/offers. SEF participants that attempt to "game" dealers on pricing would be at risk of their *firm* offers being matched, resulting in potentially unfavorable positions. The likelihood of detection for engaging in any gaming behavior, regardless of whether or not a SEF uses post-trade name disclosure in its market, also serves as a strong deterrent. Such actions carry serious reputational and enforcement risks that buy-side market participants naturally avoid.
- *Post-Trade Name Disclosure Does Not Facilitate Dealer Capital Allocation.* Contrary to some claims, MFA believes that post-trade name disclosure does not help dealers in allocating their capital among their customer base. In an anonymously executed market, there is no affirmative decision by a dealer to direct business to a particular counterparty based on a pre-existing relationship, or to reward loyal customers with better prices—the parties are transacting only on the basis of *anonymously* posted bids and offers. The pricing for a particular swap does not change when the parties' identities are disclosed to each other

post-execution. MFA does not expect that the elimination of post-trade name disclosure will have any impact on future pricing of such swap trades, because trading decisions are not based on the identity of the counterparty to begin with.

- *Concerns that Dealers Will Provide Less Liquidity to Markets Without Post-Trade Name Disclosure Lack Precedent in Similar Markets.* In electronic order-driven trading markets, it should not matter whether a dealer's counterparty is another dealer or a buy-side firm. Thus, these markets should remain anonymous to create a level playing field for all participants. Further, as the willingness and capacity of traditional dealers to allocate balance sheet to swaps market-making activities appears to be diminishing in certain respects due to Basel III's higher capital requirements, regulatory steps that promote impartial access to all SEFs encourage alternative forms of price formation and liquidity provision and greater diversity of participation (among participants and modes of interaction). These steps are essential investments for building a more robust and competitive swaps market in our country.

In MFA's view, the unintended consequence of regulatory inaction may be increased volatility in the U.S. swaps market. It is time for the CFTC to exercise its regulatory authority to prohibit post-trade name disclosure for anonymously executed, cleared swaps. By doing so, the CFTC will promote the transition to SEFs that operate in accordance with Dodd-Frank's contemplated reforms for the U.S. swaps market. We anticipate that regulatory prohibition of this practice will encourage greater voluntary trading by buy-side firms on IDB SEFs and make the SEF regime more attractive internationally, as a result of the true impartial access to these markets.

MFA petitioned the CFTC for this rule change as well as other rule changes to improve the SEF regime, as discussed below. We respectfully urge the Committee to support such changes at the CFTC.

Proposed SEF-Related Rule Amendments

MFA urges the CFTC to modify and update its SEF-related rules in light of experience with SEF trading. In October 2015, MFA submitted a petition to the CFTC to amend certain provisions of its regulations related to OTC derivatives trading on SEFs, based on MFA members' experiences to date and the "lessons learned" through the implementation process.[15] MFA's proposed amendments would: (1) codify existing CFTC staff guidance around the implementation of the CFTC's impartial access requirements; (2) codify existing CFTC staff guidance around the implementation of the CFTC's STP requirements; (3) clearly prohibit post-trade name disclosure by SEFs for swaps that are executed anonymously; (4) facilitate SEF execution of package transactions by requiring the package transaction as a whole to become "made available to trade" in order to be subject to the CFTC's trade execution requirement; (5) provide a mandatory public comment period for every "made available to trade" ("**MAT**") determination submission by a SEF under Part 40 of the CFTC's regulations; (6) establish a clear process for determining when a swap product should no longer be considered available to trade on a SEF; (7) codify existing CFTC staff guidance and no-action relief around rejection of swaps from clearing and resubmission for operational and clerical errors; (8) clarify the order interaction requirements between different SEF trading protocols; and (9) modify the definition of "block trade" in Part 43 of the CFTC's regulations to authorize on-SEF execution of a block trade as a "permitted transaction" as defined in section 37.9(c) in order to facilitate pre-execution credit checks of block trades that are intended to be cleared.

In addition, in subsequent discussions with the CFTC, the MFA also advocated for increased mandatory disclosure from SEFs regarding trading protocols, fees, and governance.

I will review MFA's supporting arguments for each of MFA's proposed amendments, other than our rationales for the requested rule to prohibit post-trade name give-up discussed above.

[15] *See* MFA Petition for Rulemaking to Amend Certain CFTC Regulations in Parts 1 (General Regulations under the Commodity Exchange Act), 39 (Derivatives Clearing Organizations, Subpart B—Compliance with Core Principles) and 43 (Real-Time Public Reporting), submitted to Mr. Christopher Kirkpatrick, Secretary of the Commission, on October 22, 2105, available at: *https://www.managedfunds.org/wp-content/uploads/2015/10/CFTC-Petition-for-SEF-Rules-Amendments-MFA-Final-Letter-with-Appendix-A-Oct-22-2015.pdf*.

Codify Existing CFTC Staff Guidance: Impartial Access

MFA's proposed amendments to section 37.202(c) would codify existing staff guidance to prohibit the use of enablement mechanisms and breakage agreements for swaps that are intended to be cleared on SEFs. A SEF that requires or permits such arrangements imposes barriers to the buy-side's access to that SEF and contravenes the CFTC's impartial access requirements. In addition, our proposed amendments prohibit a SEF from limiting access to certain types of eligible contract participants in a discriminatory manner. Such access limitations could be based on the manner in which certain types of eligible contract participants typically interact in the market, anticipated levels of trading activity, or entity registration status. These and other status-based access criteria also act as artificial barriers to the buy-side's access to SEFs.

Codify Existing CFTC Staff Guidance: STP

MFA's proposed amendments to section 1.73 would codify existing CFTC staff guidance clarifying the pre-execution risk management requirements for clearing futures commission merchants ("**FCM**") and the obligation for SEFs to facilitate compliance with these requirements.

Consistent with current CFTC staff guidance, MFA's proposed amendments to section 1.74 would establish an outer boundary of 60 seconds after submission of a trade to the clearing FCM for acceptance for clearing. Our proposed amendments would retain the current timing standard of "as quickly as technologically practicable if fully automated systems were used" ("**ASATP**") to require timing reductions for clearing acceptance from the 60 second outer boundary that continuing improvements in technology will enable.

Finally, consistent with current CFTC staff guidance, MFA's proposed amendments to section 39.12(b)(7) would establish an outer boundary of 10 seconds after submission of any trade for clearing to a CCP for the CCP to accept or reject a trade for clearing. Our proposed amendments would retain the ASATP standard to require timing reductions for clearing acceptance from the 10 second outer boundary that continuing technology improvements will enable.

More Clearly Address Package Transactions in MAT Determination Process

MFA's proposed amendments to section 37.9 would revise the definition of a "required transaction" to include "any transaction involving a stand-alone swap or any package transaction that is subject to the trade execution requirement in section 2(h)(8) of the [CEA]". We would also define a "package transaction" as follows:

> Package transaction means a transaction involving two or more instruments: (1) that is executed between two or more counterparties; (2) that is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components; (3) where the execution of each component is contingent upon the execution of all other components; and (4) where the risk of the offsetting components is reasonably equivalent.

A transaction meeting this definition would not be deemed a required transaction, unless the package transaction as a whole has become subject to the CFTC's trade execution requirement in section 2(h)(8) of the CEA.

Based on the implementation experiences of MFA members, we believe a determination should be made regarding the liquidity characteristics of the package transaction as a whole. This approach would avoid the need for CFTC staff to resort to issuing serial no-action relief as the industry continues to work on the remaining execution challenges and infrastructure solutions for certain types of package transactions.

This approach differs from the current process, where a MAT determination has implications not only for the execution of a given swap on a stand-alone basis, but also for all package transactions that include such a swap. Both the liquidity profile and the ability of market infrastructure to facilitate trading of swaps executed on a stand-alone basis *versus* as part of a package transaction can vary widely. Therefore, our changes to section 37.10 would require SEFs to apply the CFTC's MAT criteria separately at the package level to avoid execution challenges and the need for extended or permanent staff no-action relief from the trade execution requirement for certain types of package transactions.

Provide Public Comment Period for MAT Determinations

MFA's proposed amendments would require a public comment period with respect to each MAT determination submission by a SEF. We believe a mandatory public comment period would provide market participants with a critical opportunity to inform the CFTC as to a swap product's suitability and the industry's technological and operational readiness to move the product from the OTC market to SEF trading. We also believe that our proposed amendments would enable the CFTC to perform a more meaningful oversight role, furthering international harmonization.

Establish a Process for de-MAT Determinations

MFA's proposed amendments would establish a clear process for determining when a stand-alone swap or package transaction is no longer available to trade on a SEF (a "**de-MAT determination**"), based on the CFTC's current six MAT factors. We believe the CFTC should administer this process by retaining its authority to make such a determination on an annual basis or if the CFTC receives notice of de-listing submissions from at least two SEFs for a particular swap. Consistent with our request for MAT determinations, our proposed amendments would also require a public comment period to further inform the CFTC's consideration of any de-MAT determination.

We believe that a separate de-MAT determination process would serve as an important check-and-balance mechanism, rather than a process that relies exclusively on determinations of SEFs. If none of the six MAT factors support a determination that a stand-alone swap or a package transaction is made available to trade, as confirmed objectively by the CFTC's broader view of market trading data for the product in question, the CFTC should issue a public de-MAT determination order that will suspend the trade execution requirement for that product. That suspension would apply universally to all SEFs.

Codify Existing CFTC Staff Guidance and No-Action Relief: Rejection from Clearing and Resubmission

MFA's proposed amendments would codify, with clarifying modifications, existing CFTC staff no-action letter 15–24 that facilitates the correction of operational or clerical errors made in the submission of a swap to clearing. Specifically, the current no-action letter authorizes the resubmission of a corrected trade that matches the terms and conditions of the erroneous trade, other than the relevant operational or clerical error and the time of execution. MFA's proposed amendments would also further codify the treatment of an intended-to-be-cleared swap that is rejected from clearing (*i.e.,* void *ab initio*), which MFA strongly supports.

We note that ESMA included both void *ab initio* and a resubmission procedure in its published regulatory technical standards under MiFID II. As a result, codifying these points would further harmonization between SEFs and MiFID II trading venues.

Clarify RFQ and Order Interaction

MFA's proposed amendments to section 37.9(a)(3)(i) involve the CFTC's requirement that firm bids and offers must be taken into account and communicated to an RFQ requester along with the RFQ responses. These amendments would further clarify that any firm bid or offer that is communicated to an RFQ requester in this situation must be provided in an executable form so that the RFQ requester can easily access such price if so desired. In addition, as SEFs continue to make innovations in trading protocols, it is important that the order interaction requirement not be construed so narrowly as to render it inapplicable for these new trading protocols. As a result, these amendments would clarify that a SEF must communicate to an RFQ requester any firm bid or offer pertaining to the same instrument resting on any of the SEF's markets, trading systems or platforms. We believe these amendments promote pre-trade price transparency by ensuring the RFQ requester has the ability to view and access competitive firm quotes anywhere on the SEF.

Codify Existing CFTC Staff No-Action Relief: Eliminate "Occurs Away" Requirement for Authorized On-SEF Execution of Block Trades

MFA's proposed amendments would codify, with modification, existing CFTC staff no-action letter 14–118 by eliminating the "occurs away" requirement for block trades. More specifically, our proposed amendments would expressly authorize on-SEF execution of any block trade as a permitted transaction. By doing so, a block trade can be executed by RFQ to 1 or by voice to facilitate the requisite pre-execution credit checks of block trades that are intended to be cleared.

Increased Mandatory Disclosure from SEFs regarding Trading Protocols, Fees, and Governance

In November 2015, the CFTC issued a notice of proposed rulemaking regarding "Regulation Automated Trading", which included a provision requiring a designated contract market ("**DCM**") to provide additional public information regarding its market maker and trading incentive programs. MFA supported such requirement and, in addition, recommended that the CFTC require SEFs to make similar types of market maker and trading incentive program disclosures. Applying these transparency requirements to SEFs would level the playing field with DCMs, as DCMs may directly compete with SEFs by listing swaps or economically similar contracts. MFA believes that such disclosure requirements will provide investors and the broader public with more information and transparency into DCM and SEF market maker and trading incentive programs, and we agree with the CFTC that such disclosure will enhance market integrity.

Further, it is our view that market participants can benefit from greater transparency from SEFs regarding other important aspects of their offering, including trading protocols, fees, and governance. Ensuring that this type of information is consistently provided to market participants, will level the playing field and ensure that all investors can make informed decisions regarding whether to join a particular platform.

Conclusion

On behalf of MFA, I appreciate the Committee's review of the impact of the G20 clearing and trade execution requirements. As discussed, we believe that the CFTC should expand mandatory central clearing to IRS denominated in all G10 currencies. We also believe that the CFTC should engage in further rulemaking to ensure anonymous and impartial access to SEFs so as to promote an open, competitive, and level playing field. In addition, we respectfully ask Congress to encourage the Basel Committee to modify the Basel III leverage ratio to ensure that central clearing remains affordable for customers. We believe that, by promoting central clearing and organized trade execution in the OTC derivatives markets, these measures will advance the G20's and Congress's goal of reducing systemic risk.

MFA is committed to working with Members and staff of Congress, the Committee, and regulators to reduce systemic risk, ensure affordable and impartial access to our financial markets, and strengthen our nation's economy. Thank you for the opportunity to appear before you today. I would be happy to answer any questions that you may have.

The CHAIRMAN. Thank you, Mr. Berger.

Mr. Zubrod.

STATEMENT OF LUKE D. ZUBROD, DIRECTOR, RISK AND REGULATORY ADVISORY SERVICES, CHATHAM FINANCIAL, KENNETH SQUARE, PA

Mr. ZUBROD. Good morning, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. I thank you for the opportunity to testify today regarding certain derivatives-related aspects of Dodd-Frank.

My name is Luke Zubrod, and I am a Director at Chatham Financial. Chatham is an independent firm providing advice and services to businesses that use derivatives to reduce their interest rate, foreign currency, and commodity price risks. Based in Pennsylvania, we serve 1,800 firms globally, including clients in every state represented by Members of this Subcommittee.

Our clients' risk reduction activity benefits the global economy by allowing a range of businesses, from manufacturing to agriculture, to real estate to financial services, to improve planning and forecasting, and offer more stable prices to consumers and a more stable contribution to economic growth.

Chatham appreciates this body's bipartisan efforts to address key concerns of non-financial end-users following the passage of Dodd-Frank, including efforts to clarify that margin and clearing requirements should not apply to nonfinancial end-users and their centralized treasury units. These efforts were instrumental in eliminating key barriers to efficient access of the derivatives market.

Today, I will identify two similar barriers affecting a range of financial end-users that use low volumes of derivatives to reduce risk. In particular, clearing and margin requirements when applied to those transacting low volumes of OTC derivatives deter such end-users from managing their risks, cause them to manage their risks poorly, or dictate that they do so at significant expense.

Chatham's clients facing unwarranted burdens due to clearing and/or margin requirements touch a wide variety of industries, including corporates deemed to be financial in nature, real estate and infrastructure funds that make cross-border investments in buildings, railroads, ports, *et cetera,* regional banks that are contemplating using derivatives to serve their customers, reduce risk, or compete with larger banks in their footprints, microfinance funds whose capital is directed toward enabling the world's poor to lift themselves and their families from poverty in developing countries.

The first burden such firms face relates to the cost of clearing for such low volume users. Clearing members typically charge minimum monthly fees to establish a relationship that would enable a customer to comply with the clearing mandate. These fees vary by firm and customer, but typical fees amount to $100,000 per year or more. A firm hedging interest rate risks for a single 5 year bank loan will thus obligate itself to $½ million in fees over that period, just to have the privilege of hedging in the OTC markets.

The second burden relates to risk imposed by the margin requirements which expose a company to liquidity risk that many firms are unwilling to take on. Liquidity risk is the risk that a sudden sharp movement in market conditions could force a company to come up with sums of cash that are significant to the company on short notice. In an extreme case, such margin calls could cause a firm to default on an obligation.

Consider a firm with a 5 year interest rate risk, concerned that in today's historically low interest rate environment, increasing rates could adversely affect their ability to make payroll. Such a firm could fully eliminate such risk by entering into a 5 year interest rate swap to lock in a fixed interest rate. On $100 million, 5 year swap, subject to clearing or margin requirements, a firm would need to post approximately $2 million at inception, which could grow to as much as $12 million in a normally stressed market, and $25 million in an extremely stressed market, such as was seen during the financial crisis. These costs and risks create unintended consequences by negatively impacting the risk management decisions many firms make, causing them to stop hedging and retain risks that may harm business performance or even firm viability, hedge poorly in ways that cause them to retain risk, or hedge at significant expense and attempt to pass on cost to customers.

While the benefits of clearing were widely understood when Congress enacted the clearing mandate, the costs were not. We now understand clearing to be a system that simply does not accommodate small and low-volume users. The consequence is that entities whose derivatives use has no ability to undermine financial stability are cut off from properly or effectively managing their risks. Small financial end-users are essentially thrown into a raging sea of market volatility without a dependable life preserver.

These concerns could easily be addressed if Congress exempted low-volume users from clearing and margin requirements via a financial entities *de minimis* exception. Such an exception could be narrowly tailored to ensure that firms that meaningfully contribute to systemic risk would not be eligible. Such an approach is consistent with approaches adopted or proposed by Australia, Canada, Japan, and Singapore.

Thank you for the opportunity to testify today, and I am happy to address any questions you may have.

[The prepared statement of Mr. Zubrod follows:]

PREPARED STATEMENT OF LUKE D. ZUBROD, DIRECTOR, RISK AND REGULATORY ADVISORY SERVICES, CHATHAM FINANCIAL, KENNETH SQUARE, PA

Good afternoon, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. I thank you for the opportunity to testify today regarding aspects of the Dodd-Frank Act that emanated from the G20 agenda for OTC derivatives. My name is Luke Zubrod and I am a Director at Chatham Financial ("Chatham"). Chatham is an independent advisory and technology firm providing services to businesses that use derivatives to reduce their interest rate, foreign currency and commodity price risks ("end-users"). A global firm based in Pennsylvania, Chatham serves as a trusted advisor to over 1,800 end-user clients annually ranging from Fortune 100 companies to small businesses, including clients headquartered or doing business in every state represented by Members of this Subcommittee. Since our founding in 1991, we have advised clients on nearly $4 trillion in hedging transactions.

Chatham's clients rely on derivatives to reduce business risks, not for trading or speculative purposes. This risk reduction activity benefits the global economy, by allowing a range of businesses—from manufacturing to agriculture to real estate to financial services—to improve planning and forecasting, and offer more stable prices to consumers and a more stable contribution to economic growth.

Chatham supports the Dodd-Frank Act's aims of reducing systemic risk and increasing transparency in the derivatives market. We also appreciate the bipartisan efforts of this body to ensure that regulatory burdens are proportionately applied, taking into account an entity's potential ability to jeopardize financial stability. In particular, we appreciate efforts to address key concerns of nonfinancial end-users following the passage of Dodd-Frank, including efforts to clarify that margin and clearing requirements should not apply to such end-users and their centralized treasury units. These efforts were instrumental in eliminating key barriers to efficient access of the derivatives market.

Today, I will identify two similar barriers affecting a range of financial end-users that use low volumes of derivatives to reduce risk. In particular, clearing and margin requirements, when applied to those transacting low volumes of OTC derivatives, deter such end-users from managing their risks, cause them to manage their risks poorly or dictate that they manage such risks at significant expense. Indeed, per transaction costs for low-volume users are especially high when compared to the costs applicable to larger users—a fact that is at odds with their relative contributions to systemic risk.

Chatham's clients facing unwarranted burdens due to clearing and/or margin requirements touch a wide variety of industries, including the following:

- **Corporates** deemed to be financial in nature under Title VII (*e.g.,* technology companies that process certain types of payments);
- **Real estate and infrastructure funds** that make cross-border investments in buildings, railroads, ports and other such physical assets;
- **Regional banks** that use limited quantities of derivatives products or are contemplating using such products to serve their customers, reduce risk or compete with larger banks in their footprints, and that do not otherwise qualify for the small bank exemption; [and]
- **Microfinance funds** whose capital is directed toward enabling the world's poor to lift themselves and their families from poverty in developing countries.

While the businesses in which these firms engage vary widely, such firms share at least two characteristics: they (1) use derivatives to manage and reduce risk and (2) do not use quantities of derivatives that are sufficient to jeopardize financial market stability.

Let's consider the burdens such firms face, assess whether such burdens are necessary for the mitigation of systemic risk and consider what actions might alleviate unnecessary burdens.

The first burden relates to the **cost of clearing for low-volume users.** Clearing members typically charge minimum monthly fees to establish a relationship that would enable a customer to comply with the clearing mandate. These fees vary by firm and customer but typical fees amount to **$100,000 per year or more.** Consider a firm that does not qualify for the end-user exception and needs to hedge a single interest rate risk over a 5 year period, as might be the case for a firm entering into a variable rate bank loan. That firm will obligate itself to **$½ million** in fees over that period just to have the privilege of hedging in the OTC derivatives market.

The second burden relates to **risk imposed by the margin requirements** applicable to cleared swaps and soon to be applicable to swaps that are not centrally cleared. Margin requirements expose a company to new risks that many firms are unwilling to take on—especially liquidity risk. Liquidity risk is the risk that a sudden sharp movement in market conditions could cause a company, via a margin call, to come up with sums of cash that are significant to the company on short notice. In an extreme case, such a margin call could cause a firm to default on an obligation. At a minimum, a firm will need to hold back funds that it might otherwise invest in its business to ensure it has enough cash on hand to meet margin calls.

Consider the aforementioned firm with a 5 year interest rate risk. Such a firm might be concerned that in today's historically low interest rate environment, increasing rates could adversely affect their ability to make payroll. In the OTC derivatives market, such a firm could fully eliminate such risk by entering into a 5 year interest rate swap to lock in a fixed interest rate. Prior to the clearing mandate, such a firm might have been able to negotiate a credit arrangement that did not require it to post cash margin. Rather, banks were able to manage credit risk to such borrowers through a variety of other means. The borrower was able to enter into the swap without any up-front fees—all costs associated with the swap were included in the fixed interest rate paid to the bank. On a $100 million swap, a firm would need to post approximately $2 million at inception, which could grow to as much as **$25 million** in a stressed market such as was seen during the financial crisis (or approximately $12 million in normalized market conditions). These amounts are illustrative of liquidity risks and would not need to be diverted from productive use if a firm were exempt from the clearing and margin requirements.

These costs and risks create unintended consequences by negatively impacting the risk management decisions many firms make. In particular, a firm's risk management behavior may change in three ways: the firm may (1) stop hedging, (2) hedge poorly or (3) hedge expensively.

1. **Stop Hedging:** Some firms respond to the high cost of clearing and margining by choosing not to hedge, retaining risk in their businesses that could unnecessarily jeopardize business performance or, in extreme cases, even a firm's viability.
2. **Hedge Poorly:** Some firms enter into risk management products that force them to retain some risks. For example, some firms avoid the liquidity risk associated with cleared and margined swaps by managing their risks with products like options that do not create uncertain demands on a company's cash. While this may satisfy a firm's risk management objective in the short term, option products generally become very expensive when hedging for longer periods, and so companies often buy less protection, increasing their exposure to financial market gyrations over the long-term.
2. **Hedge Expensively:** Some firms may proceed with entering into cleared swaps, but incur the substantial costs to do so. This in turn increases the cost of their services and/or dampens their ability to deliver returns to investors like pension funds.

While the benefits of clearing were widely understood when Congress enacted the clearing mandate, the costs were not. We now understand central clearing to be a system that simply does not accommodate small and low-volume users. The consequence is that entities whose derivatives use has no ability to undermine financial stability are cut off from properly or effectively managing their risks. **Small financial end-users are essentially thrown into a raging see of market volatility without a dependable life preserver.**

These concerns could easily be addressed if Congress exempted low-volume users from clearing and margin requirements via a financial entities *de minimis* exception. Such an exception could be narrowly tailored to ensure that firms that meaningfully contribute to systemic risk would not be eligible. Congress has already recognized the principle underlying such an exception in Title VII of Dodd-Frank. However, that principle was narrowly applied to small banks and credit unions (*i.e.,* those with less than $10 billion in assets) and does not include the various types of market participants identified in this testimony.

Numerous foreign governments, including Australia, Canada, Japan and Singapore, have exempted or proposed to exempt a range of financial entities whose transaction volumes are relatively small from their clearing and/or margining rules, effectively acknowledging the burdens such requirements create for smaller entities and the limited public policy benefits of encompassing such entities within the requirements' scope.

On the basis of the evidence now available on the cost of clearing and margin, the extent to which such costs adversely affect low-volume users, the recognition that such entities have limited ability to undermine financial stability, and the extent to which foreign governments have similarly exempted low-volume users, we urge policymakers to enact a financial entities *de minimis* exception from clearing and margin requirements. We believe such a policy would provide needed relief without increasing systemic risk.

We appreciate your attention to these concerns and look forward to supporting the Subcommittee's efforts to ensure that derivatives regulations, while fully reflecting the policy objectives of Dodd-Frank, do not unnecessarily burden American businesses, jeopardize economic growth, or harm job creation by creating barriers to tools used to reduce the risk of investing in the economy.

Thank you for the opportunity to testify today and I am happy to address any questions you may have.

The CHAIRMAN. Thank you. Thank you all for your testimony.

The chair would like to remind Members that they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing. After that, Members will be recognized in order of arrival. I appreciate Members' understanding.

I now recognize myself for 5 minutes.

Mr. Edmonds, as we start this hearing, I want to put part of today's conversation about recovery and resolution in context. U.S. clearinghouses are robust financial institutions with significant financial resources at their disposal. The recovery or resolution of a clearinghouse like ICE or CME would be unprecedented. Can you describe what would have to happen to exhaust the resources of a major clearinghouse like ICE?

Mr. EDMONDS. So let's back up and remember that we all serve international customers, and given the European regulation around qualified CCPs coming out of the European equivalence debate that we have had, means that if you are deemed systemically important, either you have to meet that if you are a European clearinghouse, or you are going to voluntarily subscribe to those types of robust structures. So that means that simultaneously two of your largest members are defaulting on exactly the same day, at the same time. And your model right now has to be able to support enough collateral to hold against that happening.

So if you ask me what happens if we are not going to be able to survive that, it is going to be more than what those standards are, obviously, to get to that point. And that means you are going to be in a very stressed market situation, one that is likely unprecedented. If you look back at the history of the 2008 crisis, you are going to find yourself in a position where we all stress test to what those events were, the price shocks that we saw to the marketplace and the instruments that we held or we do hold now, based on a historical look back to that. So we know we can sustain two. We know we can sustain likely more than that, but we have to prove every day that we have tool sets in order to survive that.

If you ask me what happens if it is five or six, I am not sure you are worried about us at that point in time. There is a bigger problem going on in the global financial markets at that point in time. But the short answer is you have to be able to cover at least more than two going down at the same time.

The CHAIRMAN. Ms. Rosenberg, clearinghouses are bigger today, but as we talked about at our last hearing, clearing members are also required to hold more capital than they did before the crisis. How has this changed your concerns about clearinghouse risk?

Ms. ROSENBERG. Thank you for the question. I would just reiterate one point that my colleagues here at the table also made, is that in terms of capital that we have to hold against the guarantee that we provide on behalf of our customers to the clearinghouse. We are currently facing a situation with the leverage ratio where the cash that we receive from our customers is actually risk-reducing because it offsets the exposure that we have to the clearinghouse. And so that has been an impact from our standpoint in terms of the capital that we need to hold, and as a result, we are seeing a contraction with several other clearing members actually exiting the market, and there is greater concentration with respect to the market, which is not a good thing for end-users.

The CHAIRMAN. Mr. Duffy, in a speech last year, Chairman Massad noted that clearinghouse risk couldn't just be understood in terms of skin-in-the-game, and that you also had to look at the full picture of policies and practices that mitigate risk. What policies and practices have changed over the last 6 years to better manage risk within your clearinghouse?

Mr. DUFFY. Well, there have been a number of different situations that we have done, and Mr. Edmonds outlined them, but we are all new to OTC clearing, which is what we are talking about today. Historically, when you look at CME Group and our base businesses, which is futures, we have never had a default to date due to a customer loss. So that is one of the biggest issues.

When you look at the way things are margined today, since Dodd-Frank was put into place, we mark-to-market every day, and we can mark-to-market every hour. The capital that we accept today is different than it was as little as 5 or 10 years ago, so it is much more liquid than it was before.

Those are a couple of the different issues that we have done to bolster our clearinghouse. And we have, again, the risk management associated with the clearinghouse is critically important to us. The governance that is associated with our clearinghouse is important. We are working with agencies constantly. We are deemed a systemically important financial market, so these are all different things that we have to cooperate with and we have done a good job at it.

The CHAIRMAN. Thank you. I have a couple of other questions but I am going to try to hold to the 5 minute rule and come back for a second round of questions, and try to hold every Member to that as close as we can.

I will now recognize the Ranking Member, Mr. Scott, for 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Chairman Scott.

My concern in this entire harmonization cross-border equivalency issue has been to make sure that our financial firms, our clearinghouses, our market participants, are not put in a competitive disadvantage in the global marketplace. Mr. Duffy, from your testimony I get a sense of rising concern, even though we have had the December 2015 moved by the CFTC, and now we have the May 24 rule, but you still have some great concerns. And from your testimony, as I was reading it, you said, "that if this is not the case, then regulation will artificially influence liquidity, price discovery, risk management, and competitively disadvantage our market participants in an increasingly competitive global marketplace", which goes to my concern.

So you are telling me that instead of let my heart not be troubled, you are saying let our hearts be troubled. Could you tell us why you feel, even in the midst of the great work, and I tip my hat, that Chairman Massad has done, that you still have some indigestion on this issue, that you and I both are very much concerned about.

Mr. DUFFY. Thank you, sir. One of the things that I have noticed in my 36 year career at the CME, and trading for 23 of those, and then being in management for the last 15, and especially going through regulation, is uncertainty from market participants. It is the worst thing you could possibly have is not knowing what the rules of the road are. So when we talk about the equivalence equation that was originally done in February, what happens is they keep bumping up against the dates, the market participants aren't certain what the rules or the regs are going to be, what jurisdiction they can participate in. And that is exactly what happened again under the equivalence.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. DUFFY. And as you know, we are waiting for the ESMA recognition, which I referenced in my testimony, which hopefully we were getting today or tomorrow. But we need to have that by June 21. So we are trying to keep participants knowing what their capital costs are going to be, if they are going to clear at a U.S. entity or not, because they are going to be completely different if we are not recognized. And we can't continue to bump up against these dates. Certainty is the clearest thing I can say to that, sir.

Mr. DAVID SCOTT of Georgia. All right. And, Mr. Edmonds, let me ask you, first of all I want you to give me an update on where we are with equivalence for clearinghouses.

Mr. EDMONDS. Well, as Mr. Duffy said, we still have these dates. So we know where we are going to land the airplane. We may not know when we are going to land that airplane, is the easiest way I could give you that analogy.

Mr. DAVID SCOTT of Georgia. Yes. Okay.

Mr. EDMONDS. So the conceptual agreement that the global regulators have on the equivalence is well understood. It is still the details in that concept that are causing some people angst, as you articulated in previous comments on that. Things like anti-pro-cyclicality measures, you have three different options that you can use in order to meet the global benchmark. Well, no one yet knows which of those three everyone is going to use at a given time. So we know we have to get to that endpoint, but that endpoint is not there yet, and then while that endpoint is well defined, the path there is not yet well defined. That is where we are going to——

Mr. DAVID SCOTT of Georgia. All right. And, Ms. Rosenberg, let me ask you, do you think that the clearing mandate that we have has been a positive development, and if not, or even if so, what more do you specifically think the CFTC should do?

Ms. ROSENBERG. Thank you for the question. I think that the G20 global derivatives reforms overall have made the system safer and more resilient and increased transparency.

It has been several years now since global standards have been developed for clearinghouses. They were set in 2012 by the global standard setter, CPMI–IOSCO. We believe it is time, and it has been, and regulators have been taking a step back over the last 18 months to revisit those standards, as market participants have raised concerns about different areas. I spoke about this in my oral remarks, which is CCP risk governance and capital contributions, stress testing, specifically setting minimum prescriptive standards for clearinghouse stress testing, as well as with respect to stress testing, ensuring that there is a supervisory regulatory-driven stress test that reviews those financial safeguards to ensure that they are adequate.

CPMI–IOSCO has taken that feedback onboard from market participants and is in the process of developing a market consultation to cover all of these areas; capital, skin-in-the-game, governance, margin, as well as stress testing. And we look forward to U.S. regulatory participation and support, including the CFTC, in those discussions.

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman.

The CHAIRMAN. I now recognize Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman. And I appreciate you holding this hearing. These, obviously, are complex issues, and it is an example of why it is so important that we hear directly from the financial sector that is impacted by the reforms that have taken place in our markets and our market participants.

I would like to continue the discussion that has been going on about the CCP risk management and the equivalency, and my first question I will throw out to the crowd, it becomes quite clear there is an agreement with the panel that significant progress has been made in enhancing the standards for risk management at CCPs, and that global coordination among regulators in developing those standards. And obviously, the European Commission is preparing legislation to address CCP recovery and resolution.

Would the group, and whoever would prefer to go, in what order I don't care, would you expand for a bit about the various challenges that the CCP equivalency agreement, that was just reached between CFTC and European Commission, represent to your industry and ultimately to your consumers or customers?

Mr. DUFFY. I will start. I think that the agreement that we reached is one of those agreements that, as I said earlier, took way too long, which could affect the consumers because of the uncertainty of it. I think that we had to bend it a little bit here in the United States in order to get deemed equivalent, which concerns us a little bit. We want to make certain that our regulators are regulating the U.S. markets, and not a foreign regulator regulating the

U.S. markets. That is the way I look at it. So I don't want them being our Prudential Regulator.

There was a lot of back and forth, and hopefully we are in a place right now, Mr. Edmonds mentioned *pro-cyclicality,* there has been a lot of pro-cyclicality back and forth on these agreements that we never had to adhere to before as a U.S. entity, that we are adhering to today, in order to be deemed equivalent in the European Union.

Maybe that is just progress, the way it goes back and forth; but, overall, it should not hurt the business here in the United States now that we have gotten to this certain point.

Mr. LUCAS. Absolutely. And that makes me think of Mr. Scott, the Ranking Member's comment about the disadvantage. I don't think anyone in this Committee wants the industry and the United States or the participants here to be put at a disadvantage. And where are we in those circumstances? And I throw that again to the rest of the panel.

Ms. ROSENBERG. So one of the things going on in Europe right now is that we expect the European Commission to be drafting legislation on CCP recovery and resolution. We expect that to come out close to the end of the year. I suspect it could go into next year.

In any case, in the U.S. market, we don't require any specific legislation to implement recovery and resolution standards. Okay. What we want to make sure about also is that any legislation that is developed in Europe does not cause differences with the U.S. rules and legal environment. The Financial Stability Board is in the process of developing global standards with respect to resolution planning for clearinghouses, what the plans, what the guidance should be around developing those plans for resolution authorities with respect to CCPs. We would encourage the Europeans and Chairman Massad, through his discussions with the European Commission, to ensure that those standards that are developed are consistent across Europe and U.S. We wouldn't want any differences and go through another equivalence type of discussion that we have had, and Mr. Duffy elaborated on.

Mr. LUCAS. Mr. Duffy.

Mr. DUFFY. Yes, what I think is important is we do have a resolution recovery and stress testing here on U.S. CCPs that is overseen by our regulator. I don't disagree with my colleague, it would be nice to have a uniform approach across the globe, but what is important to us is that we do have that within our U.S. regulator right now.

Mr. LUCAS. Ms. Rosenberg, let's continue along this vein. Could you discuss with us for a moment the current models for stress testing, what weaknesses that might exist, how those could be addressed, because it seems, and Mr. Edmonds too, for that matter, it seems that the stress testing process modeling is absolutely important?

Ms. ROSENBERG. Yes, it absolutely is important. And I just want to mention my partners over here, Mr. Edmonds and Mr. Duffy, I don't want there to be any perception that the companies they work for, the stress testing models are not robust, or anything like that. What I am talking about is, I have responsibility for overseeing JPMorgan's 50 derivative clearinghouse memberships globally, and from that perspective, I will say that the current global standards rules that govern clearinghouses on stress testing are very light. They effectively say that clearinghouses should stress test their portfolios and use scenarios that are extreme but plausible. It is very light on the prescriptive standards. And so what we have raised, JPMorgan, other clearing members, as well as end-users, to the global standard setters, that there needs to be more prescriptive standards. And that would cover those kinds of assumptions and basic parameters about how that work should be done.

Separate from that, we do believe that there should be, like ESMA has just completed, ESMA is the European regulator that oversees CCPs in Europe, they just completed a stress test, overseen by the regulator, across 17 European CCPs. We believe, and the results were transparent to the market, and we believe something like that would provide more confidence in CCP structures.

Mr. LUCAS. Mr. Chairman, my time has expired, but if there is another round, we may continue along this vein.

The CHAIRMAN. Yes, sir, and it expired a minute ago.

The chair now recognizes the gentleman from California, Mr. Aguilar.

Mr. AGUILAR. Thank you, Chairman Scott. And I don't want to be admonished so I will make sure I stick to my time.

Some of my colleagues have gone down this road. And, Mr. Edmonds, you talked about the global nature of this market, and, Ms. Rosenberg, you just commented on the same from the regulatory framework abroad. So I will make this to Mr. Berger, Mr. Merkel, Ms. Rosenberg, and Mr. Zubrod.

Can we go down that path a little further? I am interested to know about the financial regulatory structure in other countries and how that is going to impact the swaps market.

Ms. Rosenberg, you just talked about the European discussion moving forward, and earlier you talked about continued discussions in the regulatory structure abroad. Can we talk about the impact that will have on the U.S. swaps market?

Ms. ROSENBERG. Sure. I am happy to start. Thank you for that question. That is a very important question.

One of the things we have seen with respect to SEFs and market liquidity is that there could be certain enhancements made in the U.S. CFTC rules to curtail the current market fragmentation that we have seen between Europe and the U.S. We expect the European regulators to develop specific rules around SEFs going into next year. And currently, the U.S. rules are very prescriptive with respect to how swap dealers can execute trades, and we do believe that there needs to be more flexibility on that front because we expect that is where the Europeans are going. And that is very important. And I do believe that the CFTC and Chairman Massad are very supportive of this.

Mr. AGUILAR. Mr. Merkel?

Mr. MERKEL. I would agree with that. What we have seen is that there were good intentions on the part of the CFTC to try to lead and try to get other jurisdictions to harmonize forms of execution. It just didn't work. What ultimately ended up happening was it chased away non-U.S. participants, and led to markets developing outside the United States, which did fragment liquidity. It is not a crisis, just unfortunate, and doesn't really benefit anyone. From our perspective, we will do the business wherever it is. We will do it in New York, we will do it in London. And we will have to see what happens with MiFID II and how the U.S. agency approaches it. I do think that one should be realistic and be somewhat courteous of what is going on in Europe, and understand that they don't have to come here. And it may well be that we may face a situation in which at some point U.S. firms aren't going to be able to do business in Europe as easily, and that would be unfortunate for a number of reasons. And the best way to do this is to encourage what we think is starting to occur, which is a different approach that Chairman Massad is taking, and see what develops.

We are in a cautiously optimistic mode, provided something happens. If nothing occurs, we are going to have a problem. I just don't, at the moment, think I might be optimistic, but that is not likely.

Mr. AGUILAR. Thank you. Mr. Berger?

Mr. BERGER. We are likewise optimistic that a harmonized and mutually recognized regime can be put in place for both clearing and trading. On the clearing front, as I noted in my opening remarks, the scope of the clearing obligation that is going to be phased in in Europe beginning this year is identical in scope to what has been already put in place in the U.S.

On the execution side, the good news is there is common architecture that has been developed. Europe has adopted the same execution of clearing workflow and straight through processing rules that the CFTC has put in place. And there is a commitment in both regimes that trading venues should provide impartial and non-discriminatory access to all market participants.

There is a path forward. Obviously, the European regime is a few years being. Clearing is just being phased in there this year, and we phased clearing in in 2013. And as other commenters have noted, the MiFID II reforms, which will affect trading in Europe, come into effect in 2018. So there is a timing differential, but the objectives and the end state is consistent across both.

Mr. AGUILAR. Thank you. Mr. Zubrod, real briefly.

Mr. ZUBROD. Yes, I will note with respect to my testimony the comparison with Singapore, Australia, Japan, and Canada, these are governments who have enacted what amounts to exceptions to clearing and/or margin in their regimes, and the implication for them is that such market participants will not be unnecessarily burdened, whereas those here in U.S. markets will be by these requirements.

Mr. AGUILAR. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The chair now recognizes Mr. Neugebauer, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Duffy and Mr. Edmonds, we have talked a lot about clearinghouse governance, and so how do you determine what level of risk a clearinghouse takes on, and then what are your primary tools that you use to manage that risk?

Mr. EDMONDS. Those decisions are made at a risk committee level, which is part of the defined part of the governance structure.

A recommendation is made, whether it is a new product, a new member coming into the clearinghouse that is going to bring their own level of customer flow into the clearinghouse at the time. And once that decision is made to launch those new products or to add on that new member, we are constantly looking at the entire book, the match book. At no point in time do we run an unmatched book. The only time that ever happens is if one of the members is defaulting, and our job at that moment in time is to bring it back to match book as quickly and as efficiently as possible, with as little disruption to the marketplace as possible.

Making certain that all of the members that we govern through the clearinghouse structure and the way it is set up under the CFTC, that we understand the risks they are bringing, and the collateral they bring to support that risk on a daily basis is the function of the clearinghouse, and continues to be the primary responsibility that we have to the marketplace.

From a tools perspective, this is everything in the waterfall. Membership, not everyone qualifies. If I have $5 and you have $5 million, chances are you are a better member than I am at that day.

Mr. NEUGEBAUER. Yes.

Mr. EDMONDS. Okay. Making sure that the qualified members are there, and making sure there are operational risk controls there so they can process the customer flow. Our members, who are very important partners with us, ultimately make the decision of who gets access to our clearinghouse services. If they have done a poor job, we need to be able to spot that, and we need to be able to have a consultation with them. We don't like this position, it is too concentrated. If it is too concentrated, there are other premiums of collateral we bring in there. You may want to hold a very concentrated position, and we may be able to get comfortable with that, but you might be collateralizing that more than 100 percent of the risk that we hold. If that is something you are willing to pay, we will take that at the end of the day. And then making sure that we get all the way down through, okay, what happens if it goes the wrong way. What happens if the collateral wasn't what we thought it was going to be? How do we manage that process all through again? Membership committee: It is the same for every single person. No one is making a bilateral decision. Clearing member A gets this function. Clearing member B gets a separate function. Everyone is managed to absolutely the same standard at all times.

Mr. DUFFY. I would just add, I agree with Mr. Edmonds completely on everything he said there, but I would just add that one of the things that we have the ability to do under the Dodd-Frank Act, which was critically important when we are talking about swaps, is the ability to reject a swap at the clearinghouse CCP level if we are not comfortable with the risk that it is bringing into our institution. I think that is something we use, and margin is another tool that Mr. Edmonds also referenced. Margin is something that is important for the CCPs always to have the ability to set. We are not interested in if the price goes up or down, we are interested in managing the risk. These are the tools that we have put in place today, and I am only outlining a couple of them, Mr. Edmonds did a good job outlining the others, but these are critically important tools. When you don't have an interest in the market going up or down, that is who should be setting the margin, and the ability to reject something that you are not quite sure how to risk manage is also critically important.

Mr. NEUGEBAUER. The leverage ratio as several of you alluded to that, and so the question I have is: leverage ratio, has it caused margins to go up. So, in order to adhere to whatever the leverage ratio is pegged at, would you get credit for additional margin that you request from your members?

Mr. EDMONDS. Now, that is a bit of the perplexing piece because the more margin our members collect on their client positions and post to us, the way the rules currently stand today, the more capital they have to hold against it. So at a time where we are trying to encourage more and more individuals to use clearing services because of the risk-reducing nature of it, we are adding to that cost. The more collateral we get, the more the bank clearing members are having to hold against that. Well, they have to then charge for holding that capital against that, from a regulatory capital perspective. That increases the cost to your end-clients. And that is where this thing begins to spiral out and more people are making the decision today, if they possibly can, to choose not to be in that situation.

Mr. NEUGEBAUER. That is counterintuitive. In other words, what you are saying is the less risky you make that position, the more capital that you have to keep. Do I understand that correctly?

Mr. EDMONDS. You do. And yes, it sounds illogical, and we are trying to have a logical conversation.

Mr. NEUGEBAUER. Mr. Duffy?

Mr. DUFFY. May I just jump in real quick? What I think is critically important, and Ms. Rosenberg can answer this better than any of us because this affects her more than anybody, but what is important is her bank, or any other bank, cannot touch that collateral that is in the clearinghouse because it is segregated. There is no reason to have the leverage ratio charge put up against it. They have no access to that capital or collateral.

The CHAIRMAN. The chair now recognizes Mr. Davis, from Illinois, for 5 minutes.

Mr. DAVIS. Thank you. Thank you, Mr. Chairman. And thank you to everyone for coming here today to talk about this important issue. A lot of the questions that I had planned to ask have been asked by my colleagues. And that is the benefit of being a little further down the seniority ladder, like we are.

Let me start with you, Mr. Zubrod. Can you go into a little more detail on the impact to agricultural and energy firms moving away from the swaps market to the futures market to possibly hedge their risks?

Mr. ZUBROD. It is a good question, and I appreciate its premise. If I can discern correctly, the premise is that we should really give due consideration to players who are involved in helping to provide price stability to the kitchen table, to energy bills that consumers pay at home. My view on the key obstacles to smaller players like that in accessing the markets tends to be focused, again, on the issue of clearing and margin costs for those smaller players, not necessarily the obstacles, for example, created by SEFs or other things. There are legitimate debates about whether or not one needs to be prescriptive in defining all aspects of how SEFs need to operate, but that being said, I think that is not the key obstacle for a lot of the clients that we work with in accessing the markets. It is the significant costs associated with clearing and margin.

Mr. DAVIS. Okay. Do you have any suggestions to address some of these obstacles?

Mr. ZUBROD. Yes, again, for the clearing and margin requirements, it could be addressed very simply, and the simplistic solution is to exempt small, low-volume players from the clearing and margin requirements.

Mr. DAVIS. Okay. Mr. Duffy. How are you, sir?

Mr. DUFFY. I am good, sir. How are you?

Mr. DAVIS. Good. Nice to see you are on your wing again here. As many of you know, it was named the Terry Duffy Wing, one of the last Subcommittee hearings that I had. It was just me that named it, so sorry, Terry. We don't have a plaque up yet. Can you fix that, Chairman Scott?

Mr. Duffy, how does the CME strike the appropriate balance between profits and risk management?

Mr. DUFFY. How do they—between what, profits and risk management?

Mr. DAVIS. Yes. How does your company strike the balance between profits and risk management?

Mr. DUFFY. Risk management comes first, sir. Without risk management, we don't have profits. I have said this a million times over, the credibility of our marketplace is of the utmost importance to CME Group. We cannot shortcut any of the risk management tools or protocols that we put into place, or continue to put into place, or we will not have shareholders. We do not put profits in front of risk management. Again, this is something that is near and dear to my heart, and near and dear to everybody in the organization, because we will not shortcut that process one cent.

Mr. DAVIS. And we appreciate that.

And I will yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Davis. I now recognize Mr. Kelly, from Mississippi, for 5 minutes.

Mr. KELLY. Thank you, Mr. Chairman and Ranking Member Scott, for having this hearing. And thank you, witnesses, for being here.

I have been in and out so if I ask you something that has already been asked, I apologize.

Mr. Davis talks funny beside me, so I know that you guys can understand my accent much better than his.

Ms. Rosenberg, you were partially answering this when I walked back in, but if you want to add anything, has the clearing mandate been a positive development for the market?

Ms. ROSENBERG. Thank you for the question. Yes, we believe it has been a positive development for the market. The G20 reforms have made the system safer and more transparent. And what we are collectively doing now, market participants as well as regulators and clearinghouses, are reviewing current standards. We do expect market consultation at the global level to come out over the next couple of months to cover many of these standards that are being revisited, and they include stress testing, initial margin, governance, as well as recovery tools. And we look forward to providing that input into that process.

Mr. KELLY. And kind of as an unintended follow up, I guess, as a member of many clearinghouses, does your firm have any say in the products that are cleared in each venue, and do you have any concerns about the products that might be cleared in the central clearing counterparties JPMorgan is a member of. Further, do you think the capital and margin rules are incentivizing products to be cleared that perhaps shouldn't be?

Ms. ROSENBERG. That is near and dear to our firm's heart, as well as other clearing firms. What I haven't said in my testimony is that JPMorgan, as a firm, there are employees at JPMorgan that do sit on clearinghouse risk committees, but that role that we participate in is as a fiduciary on behalf of the clearinghouse, or as a market expert. It is not representing us as a clearing firm. What we have seen, and we think we expect it to continue to go in this direction, particularly with the non-cleared margin rules coming out, starting in September, there is an interest by participants and CCPs to clear more products. There is going to be a demand to clear more products, even if they are not mandated, more complex products. And we do think there needs to be more involvement with key stakeholders, like members, through a mandatory consultation process early in determining whether a product is suitable to clearing because the impact of clearing more complex products could impact our capital that we contribute through the loss mutualization process.

Mr. KELLY. Mr. Berger, I am talking about swaps execution facility, the SEF, can market participants limit themselves to using only one SEF, or do they need to use multiple SEFs? And if the latter, if they need to use multiple SEFs, what problems does that pose?

Mr. BERGER. Market participants are free to use one or multiple SEFs. Many buy-side market participants use the two SEFs that serve the buy-side community: Bloomberg or Tradeweb, so many buy-side market participants will use one or both of those venues. There are probably, serving the interest rate swap market and the credit default swap market, eight or nine SEFs that have a decent amount of liquidity. One of the concerns that the Managed Funds Association has, however, is that there are really only two SEFs that are truly open and accessible to customers in the market, and five or six of the other SEFs that have liquidity have to maintain certain barriers. So it would be beneficial if investors could access the full array of swap execution facilities that have liquidity.

Mr. KELLY. Thank you. And, Mr. Edmonds, we talk a lot about models and stress testing, but how good are the models and how do we know that the models developed will work in a time of stress?

Mr. EDMONDS. We have to use the best information available to us at the time. I will tell you, spending time, in my previous role at ICE, running the CDS Clearinghouse, we went back and we continued to look back at the 2008 crisis, and we looked at that and we said what if it was two times as big, what if the price differential from the Lehman Brothers' default and its impact on credit default swaps was 200 percent of what we witnessed that day. And we still hold enough capital against that today. If it is 400 percent, we might have a different conversation, but as I said earlier in one of my remarks, I might not be the thing you are looking at that day, it might be a much bigger piece.

Mr. KELLY. And thank you, Mr. Chairman. I yield back.

The CHAIRMAN. We are going to go on to our second round of questioning now. And I yield myself for 5 minutes.

Mr. Berger, members of your firm have been enthusiastic about the impact of Dodd-Frank on cleared derivatives transactions, and have worked hard to build a business as a nontraditional liquidity provider in certain swaps. Do you see the success of Citadel as the new model for swaps liquidity as banks retreat from their traditional role in these markets?

Mr. BERGER. Just one note up-front, I am here today representing Citadel's hedge funds businesses, speaking on behalf of the Managed Funds Association and Citadel Securities, which conducts swap market-making activities operates independent of Citadel's hedge funds. That said, a central goal of the swaps markets reforms was to lower barriers to entry and increase competition, and that does directly benefit investors by providing more competitive pricing and more diverse sources of liquidity beyond the historical incumbent intermediaries in the marketplace.

The CHAIRMAN. Do you think that all swaps markets are suitable for electronic market-making, and are there any liquidity challenges created by Dodd-Frank, despite the success you have seen at Citadel?

Mr. BERGER. I don't think all swap markets are suitable for electronic trading. There are portions of the swap market that remain uncleared, for example, but the portions of the swap market that are cleared and that are highly liquid and transparent, are standardized, liquid, and transparent, are appropriate to trade on swap execution facilities through electronic RFQ and order books as well. Research that has looked at the impact of the migration to SEF trading has shown that it has improved pricing and liquidity. We have heard referenced today already to the Bank of England research that was released earlier this year or, sorry, at the end of last year, that reached that conclusion, and that research has been independently validated by some other market researchers, including Claris. There are tangible benefits that market participants are realizing from these reforms.

The CHAIRMAN. So you think it has improved liquidity, and you don't see any challenges with liquidity because of it?

Mr. BERGER. I think that it has improved pricing and liquidity, and the challenges that exist with respect to liquidity in the marketplace are best addressed by ensuring that more market participants can join all the venues that are available, and that there are more diverse means of risk transfer and price discovery. So that a broader array of market participants who can be both price makers and price takers, and a more kind of diverse marketplace is the long-term solution to any liquidity challenges we face today.

The CHAIRMAN. All right. Ms. Rosenberg, late last week the European Union announced that it was delaying its margin for uncleared swaps rules. Chairman Conaway stated that this is yet another failure of international cooperation which will have real consequences for U.S. market participants. How does this sudden shift in coordination impact a bank like JPMorgan, and what other potential failures of cooperation are you worried about?

Ms. ROSENBERG. This is a really—pressed the wrong button, sorry.

The CHAIRMAN. That is all right.

Ms. ROSENBERG. This is a really important question, and it is something that policymakers and regulators need to be focused on. As you mentioned, it is a recent announcement, it just happened on Friday, and we are still considering the implications for JPMorgan, but our initial concern is that it may create disadvantage for U.S. banks. A primary priority for the industry throughout the development of these margin rules has been consistency and content and timing. So we don't want a delay in timing in one jurisdiction that could create undue burden or lack of competitiveness for U.S. firms.

The CHAIRMAN. Mr. Zubrod, if U.S. regulators go it alone with the uncleared margin rule because the European Union failed to follow through with its commitments, what will be the impact of end-users like your clients?

Mr. ZUBROD. Sure. Thanks for the question. I would say global margin rules really reflected the most careful and deliberate process across all of derivatives regulation to reach a globally coordinated outcome, and to line up the start dates globally as well. And it would be valuable to endeavor to retain a key benefit of that coordination by maintaining those aligned start dates. Failures to do so will drive imbalances in counterparty selection that have competitive implications. For example, if I were a European entity, and I had the choice of facing a European bank or a U.S. bank, one who was subject to U.S. margin rules that started earlier, and another who was subject to European rules that had not yet taken effect, if those start dates didn't match, I would have the incentive to transact with the European bank. So that is certainly a real-world implication of becoming misaligned on those dates, and we should endeavor to move forward in lockstep with Europe.

The CHAIRMAN. Yes. Thank you. I would now recognize Mr. Conaway, the Chairman of the full Committee.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Mr. CONAWAY. Thank you, Mr. Chairman.

I apologize for popping in and out, but thank you all for being here.

In Chris Giancarlo's white paper in 2015, he was critical of the limitation on methods of execution available for swap SEFs which was needed in the G20 rules and/or Dodd-Frank, but it was a part of the Gensler regime. Can any of you comment on the impact that that limitation has on the way you do your business, good or bad? Yes, Mr. Merkel?

Mr. MERKEL. Thank you, Mr. Chairman. We would agree with Commissioner Giancarlo in that respect. We faced at the WMBAA early on, there had been a bias towards exchanges and towards electronic marketplaces, and we worked hard to make sure that

Dodd-Frank ultimately provided a technology-neutral approach with respect to marketplaces that used any means of interstate commerce. And we thought at that point that the debate was over, but it turned out it was just beginning. When the proposed rules came out, they were constrained. They really were.

They continued to have issues with voice brokerage, there were issues with respect to trying to put in and prevent certain matching protocols that otherwise should have been permitted, and were successful all over the world, but the agency didn't want. Over time, we were able to work with the staff to get to a better place, but we continued to have some regulatory uncertainty. Letters for relief or guidance have been unanswered. Other areas we are in a tacit form. And you see that MiFID II has a much more expansive and flexible approach to execution than you see here. Again, while I am optimistic that it will all be harmonized, we have noticed that it has taken time and it has been difficult to get to where we have finally gotten to with respect to most, but not all, of the auction protocols. Some of the issue may be that, for the most part, the agency was used to futures exchanges but not necessarily over-the-counter markets. And what you see in the over-the-counter markets are a much broader range of methods of execution, levels of opacity *versus* transparency. And what we see with the swaps markets has been most successful, and derivatives are most robustly traded, is where you don't limit the means of execution.

Mr. CONAWAY. Right. Mr. Edmonds?

Mr. EDMONDS. I would echo that point. From a clearinghouse perspective, certainly, we run exchange businesses and we have execution protocols, but the goal of the G20 was to reduce the risk. And the only way you are going to achieve that goal at the end of the day is to be as open and agnostic as possible of how that trade is executed. But once it is executed, it goes into a system that is very regulated, very transparent, and understood about how the risk is going to be managed. And if we are going to do things that take us down a path different than that, we are not going to achieve the ultimate efficiency of that goal.

Mr. CONAWAY. The Chairman has asked about the delay by the Europeans on their uncleared swaps margin. Is there an argument to be made that the U.S. and the Asian markets should continue with that implementation date, because these are simply the biggest banks, dealer-to-dealer, and it really won't have any real impact? Is there an argument to be made about that as to why it would not be necessarily a competitive disadvantage to all the rest of the markets in the world if Europe delays it by a year? Anybody?

Mr. DUFFY. I am sure Ms. Rosenberg can speak as well as anybody on this issue, but this puts the U.S. banks at a huge disadvantage to the European banks, just for the example that was laid out at the end of the table here. I am hopeful that this implementation date that the U.S. and other countries around the world are looking at can be postponed in coordination with the European date. I just think it puts the U.S. banks at a huge disadvantage.

Mr. CONAWAY. How would the argument go as to say that if we make international agreements, and we all agree to a date, and then when we get right here at the last minute we let the lowest common denominator drop out, and then we are going to reward that bad behavior by delaying everybody else. Is there an argument that way to say, "Look, we are going to stick with it, and you guys are going to have to come to the table and get your job done the way that you should have done it the way we agreed to a year ago?" Ms. Rosenberg, or anybody?

Ms. ROSENBERG. I was just going to say that the date that is going to be the most impactful from a U.S. bank perspective is the phase two when the customers start having to post noncleared margin. That is later on to next year. As I said, we haven't looked at the full implications for JPMorgan as a firm in terms of the impacts, whether it be 6 or 9 months, and we are happy to provide more feedback on that.

Mr. CONAWAY. Well, obviously, this just happened Friday, and there are a lot of folks trying to figure out what we did to whom on that.

Thank you very much. I appreciate it. Mr. Merkel, did you have a comment?

Mr. MERKEL. It may be obvious, but I did want to make the point that there is always a trade-off between U.S. regulators wanting to insist on certain safety prudential or fairness issues to govern its participants against what the effect would be on a global basis. And they have to make a judgment at what point they need to insist upon the virtues and understand what the negative consequences would be, but it does seem as though this particular area is one in which one would expect there should be some flexibility as to the date of implementation. There does not seem to be a great urgency about it, and there would seem to be some benefit in trying to see whether or not there can be coordination globally.

Mr. CONAWAY. Yes. Mr. Berger, you had a comment?

Mr. BERGER. Thank you. I was just going to add that the timeline in both the U.S. and Europe for the implementation of these rules is phased in from 2016 to 2020 as originally envisioned, and the new uncleared margin rules don't hit the end-user or buy-side community until 2019, based on the different thresholds they have set. The September 2016 date that is being discussed now is relevant for counterparties with above $3 trillion notional in uncleared derivatives outstanding. That is really a handful of the biggest banks, but there is not a direct impact at least on the end-user in the current community.

Mr. CONAWAY. Yes. Okay. Mr. Chairman, thank you for your indulgence. I yield back.

The CHAIRMAN. Thank you. The chair will now recognize Mr. Scott.

Mr. DAVID SCOTT of Georgia. Yes. I want to get clarity now. The date of implementation is September what did you say?

Mr. BERGER. September 1, 2016, is the first implementation date.

Mr. DAVID SCOTT of Georgia. Yes. And so, Mr. Duffy, you are saying that that date puts our U.S. businesses at a competitive disadvantage if we don't move it back?

Mr. DUFFY. It certainly could. Ms. Rosenberg, obviously, works for a very global bank, and maybe it won't affect their European business, I am not sure, but the banks that are primarily U.S. banks, U.S.-regulated banks, it will affect them. But, the point is, and it is a good point, and the Chairman raised it, this just came out Friday, details are a little sketchy, and the implementation date of 2016 and then followed on by 2017. It goes back to my further point, Mr. Scott, and this is just another example of how we are going to have uncertainty in the marketplace where the market does not need uncertainty, it needs clarity. And one of the things that I have heard here amongst this panel, which, on a whole host of issues, is we need to have continuity within our European and Asian counterparts, so we can have one set of rules.

Mr. DAVID SCOTT of Georgia. I see. And you say, Ms. Rosenberg?

Ms. ROSENBERG. I would just add to what Mr. Duffy just said, which is, it is very complex. We are looking at our legal entities, we are looking at our counterparties, we are looking at where we do swaps and who we do swaps with. In September, it will impact U.S. banks, which means any counterparty that we do business with will have to post noncleared margin to us. In that instance, if our counterparties can operate or trade and execute with non-U.S. counterparties, where they don't have to post margin, then they may choose to do so. That is what we are evaluating right now, what that impact could be.

Mr. DAVID SCOTT of Georgia. When should we do it? As the Chairman has said, we have been kicking the can down the road, kicking the can down the road, kicking the can down the road 3 years, 2 years, I don't know. This Committee does not want to move in any way, we are very, very, very cautious about putting our United States companies in at a competitive disadvantage. And if you all, the banks, the clearinghouses, are agreeing that this does, let me ask you to describe that competitive disadvantage if we don't do it. What would that cause you to do?

Ms. ROSENBERG. In terms of how it would impact us, counterparties could choose to execute a swap and clear a swap bilaterally with a European counterparty that is not yet subject to these uncleared margin rules.

Mr. DAVID SCOTT of Georgia. Okay.

Ms. ROSENBERG. I mean that is the base of it. I would say that our folks internally at JPMorgan, are looking to see how much of an impact that could be. But, it gets back to the timing and the differences in timing and there was a real effort that was put forth to have consistent standards and consistent timing of implementation to avoid things like this.

Mr. DAVID SCOTT of Georgia. Yes.

Ms. ROSENBERG. So, as I said, we are looking at this, and we can come back to you with more information once we have done the full evaluation.

Mr. DAVID SCOTT of Georgia. Is there a dollar figure, is there something that is tangible that the regulators, the CFTC or whoever we would need to talk to about this date, that we could say X amount of money would be lost? Is there something we could put our hands around to really show how large and how significant an impact this would be on our American businesses if we do not adjust this September date?

Mr. EDMONDS. I don't know that we could say a dollar amount, but you could say that there is a limitation in choice because if you are going deal, assuming the date doesn't move, you are going to deal with a U.S. counterparty that is going to have to charge you some number. You may have the option to deal with a European entity that is not required to charge you some number.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. EDMONDS. If you decide that, all things else being equal, you are just going to take the path of least resistance as long as you can, that may be fine, but you also may have much, much less choice as to the number of counterparties that you can deal with. And the European counterparties realizing that you have less choice, might have the ability to increase that cost, for their benefit, to you.

Mr. DAVID SCOTT of Georgia. I see. Thank you, Mr. Chairman.

The CHAIRMAN. The chair now recognizes Mr. Lucas, for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman. Just in a way of a follow-up, Mr. Duffy, any more observations about stress test issues, weaknesses, overcoming those? The earlier discussion we had, you seemed to have an observation.

Mr. DUFFY. On the stress test? The only thing I was pointing out was that I didn't want to have the perception that CCPs in the United States don't have stress tests under its U.S. regulator, which we do. I do agree with Ms. Rosenberg, we need to have coordination with our European counterparts on this because of the businesses that they run. JPMorgan, you said, has 71 different clearing entities that they are associated with. I understand that part, but the only thing I was trying to stress was that we do have very rigorous stress tests that are overseen by our U.S. regulator today, there is just not a global standard, to Ms. Rosenberg's point.

Mr. LUCAS. So it is an ongoing, evolving process you all are completely engaged in?

Mr. DUFFY. It is always going to be ongoing. Absolutely.

Mr. LUCAS. With that, Mr. Chairman, I yield back. Thank you.

The CHAIRMAN. Mr. Conaway, do you have any thoughts?

Mr. CONAWAY. No.

The CHAIRMAN. Mr. Scott, I now recognize the Ranking Member to make any closing remarks he has.

Mr. DAVID SCOTT of Georgia. Well, again, Mr. Chairman, this has been a very timely and, quite honestly, necessary hearing. It has been very revealing. We do have some issues and concerns here. I do think we need to take under consideration the concerns that several of the panelists have raised, particularly, regarding taking a good jaundiced eye look at this date. We certainly don't want to put our businesses at a disadvantage. This is an evolving issue, it is complicated, it is confusing. You are trying to get 20 nations to harmonize, and do it on a timely basis. We do not want to do anything that would hurt American businesses. That is just my concern.

I am also concerned about this Basel III situation and the leverage ratio. I think that that is a serious issue too.

So I come away from this hearing with a heightened sense of concern. Our Committee needs to make sure we address all these issues, and make sure we move, communicate with the CFTC and continue to soldier on. And we hope we can move forward and get an execution date, but I certainly want to see some of these issues examined and cleared.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Scott.

Ma'am, gentlemen, thank you for being here and participating in this hearing.

Under the Rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplementary written responses from the witnesses to any questions posed by Members.

This hearing of the Subcommittee on Commodity Exchanges, Energy, and Credit is adjourned.

[Whereupon, at 11:40 a.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTIONS

Response from Hon. Terrence A. Duffy, Executive Chairman and President, CME Group Inc.

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Question 1. At a recent CFTC Market Risk Advisory Committee meeting a number of buy-side witnesses testified that the practice of post-trade name-give up—that is: the removal of anonymity from the market after execution, has prevented them from participating in the SEFs offered by the Inter-Dealer Brokers. Further, two class-action lawsuits alleging anti-trust violations against the largest dealers and several of the interdealer brokers have been filed in the credit default swap and interest rate markets respectively. These suits both allege that the practice of post-trade name give-up has been planned by the largest participants and forced on to the inter-dealer brokers in restraint of trade. One of them settled late last year for $2bn.

The SEF Core principles in Dodd Frank require impartial access for all eligible market participants. The CFTC's SEF Rule mandates that a SEF must ensure "impartial access to its markets and market services" for eligible participants—and that eligibility itself must be set in an impartial, transparent, fair and non-discriminatory manner.

Do all eligible market participants have impartial access to each and every SEF? If not, why not?

Answer. We are not familiar with the practices of other SEFs. However, CME Group's SEF operates in strict accord with the SEF Core principles, including supporting CFTC rules and interpretations respecting impartial access for all eligible market participants. Our SEF access rules are transparent and readily available in chapter I of the SEF rulebook (*http://www.cmegroup.com/rulebook/SEF/cme-sef-rulebook.pdf*).

Question 2. There was a great deal of testimony regarding harmonization with European Rules. However, from published reports a number of trade organizations representing incumbent firms with significant market power have been arguing to European regulators and legislators to make changes to the proposed trade execution regime in MiFID II. If that effort is successful, we will be asked to harmonize, or to push the CFTC to harmonize, our clear rules on impartial access to the SEF marketplace for eligible participants with rules that include no such mandate. In that eventuality should harmonization still be our top priority?

Answer. CME Group favors fair and impartial access to U.S. based SEFs and DCMs. We favor cross border harmonization to the extent it is necessary to permit us to operate for the benefit of customers in other jurisdictions. We do not believe that harmonization principles will require U.S. law and regulation to permit practices that are inconsistent with the existing access standards in this country. It is our view that harmonization requires a defined level of protection for customers or institutions. It should not be interpreted to require any jurisdiction to weaken its market protection standards.

Question 3. The swaps we discussed at the hearing are not customized—they are standardized. Standardized swaps are the only swaps that are subject to the trading mandate—they are cleared and are subject to the straight-through-processing requirement. And yet, we repeatedly hear that the swaps market is fundamentally different than other standardized markets: that it is characterized by episodic liquidity and that its bifurcated, two-tiered structure is the "natural" evolution of the market. Do you agree or disagree with that characterization?

Answer. We agree that episodic liquidity stemmed from the natural evolution of the market.

While the interest rate swaps that are subject to the trading mandate are referred to as "vanilla" and are comparatively standard in contrast to more highly customized interest rate swaps, most highly standardized derivatives products (such as many futures contracts) are characterized by an even greater degree of standardization than is present in most "vanilla" OTC interest rate swaps. In most cases, a swap traded today will not be offset by the same swap traded the next day. This results in very different liquidity characteristics from futures contracts, which have the same expiration and which are fungible regardless of the trade date.

The majority of "vanilla" interest rate swaps subject to a trading mandate do not have standardized coupons or dates. Products with non-standardized coupons and dates can allow market participants to achieve specific risk management needs, but will typically have a greater number and variety of instruments traded. This results in different liquidity formation characteristics than more fully standardized products that aggregate liquidity of participants across multiple dates and potential coupon rates.

The emergence of more standardized interest rate swaps, such as MAC (Market Agreed Coupon) swaps, and the development of related swap futures by multiple global exchanges are likely to have a significant impact on the evolution of the swap market toward a more standardized, liquid trading venue.

Response from Christopher S. Edmonds, Senior Vice President, Financial Markets, Intercontinental Exchange, Inc.

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Question 1. At a recent CFTC Market Risk Advisory Committee meeting a number of buy-side witnesses testified that the practice of post-trade name-give up—that is: the removal of anonymity from the market after execution, has prevented them from participating in the SEFs offered by the Inter-Dealer Brokers. Further, two class-action lawsuits alleging anti-trust violations against the largest dealers and several of the interdealer brokers have been filed in the credit default swap and interest rate markets respectively. These suits both allege that the practice of post-trade name give-up has been planned by the largest participants and forced on to the inter-dealer brokers in restraint of trade. One of them settled late last year for $2bn.

The SEF Core principles in Dodd Frank require impartial access for all eligible market participants. The CFTC's SEF Rule mandates that a SEF must ensure "impartial access to its markets and market services" for eligible participants—and that eligibility itself must be set in an impartial, transparent, fair and non-discriminatory manner.

Do all eligible market participants have impartial access to each and every SEF? If not, why not?

Answer. ICE Swap Trade offers a multitude of methods of access related to credit default swaps including an all to all anonymous marketplace, broker access and name give ups. By offering various methods of access, ICE complies with SEF regulations which are intended to promote fair, non-discriminatory and open access. The ICE Swap Trade platform will accept a transaction, either cleared or bilateral, as long as the transaction meets the SEF requirements.

Question 2. There was a great deal of testimony regarding harmonization with European Rules. However, from published reports a number of trade organizations representing incumbent firms with significant market power have been arguing to European regulators and legislators to make changes to the proposed trade execution regime in MiFID II. If that effort is successful, we will be asked to harmonize, or to push the CFTC to harmonize, our clear rules on impartial access to the SEF marketplace for eligible participants with rules that include no such mandate. In that eventuality should harmonization still be our top priority?

Answer. The Rules on access to trading venues under MiFID II were agreed to in the Level 1 legislation. The Level 1 legislation requires trading venues to have in place transparent and non-discriminatory rules based on objective criteria which govern access to their facility. These requirements are comparable to the impartial access rules for SEFs. ICE believes harmonization between global regulators is critical and should be a prioritized accordingly.

Question 3. The swaps we discussed at the hearing are not customized—they are standardized. Standardized swaps are the only swaps that are subject to the trading mandate—they are cleared and are subject to the straight-through-processing requirement. And yet, we repeatedly hear that the swaps market is fundamentally different than other standardized markets: that it is characterized by episodic liquidity and that its bifurcated, two-tiered structure is the "natural" evolution of the market. Do you agree or disagree with that characterization?

Answer. ICE agrees that although certain interest rate and credit default swaps have been standardized and mandated for both execution and clearing, current regulations have unintentionally created a bifurcation in these swaps markets. New regulations that require fully anonymous trading would be necessary to remove this bifurcation.

Response from Marnie J. Rosenberg, Global Head, Clearinghouse Risk and Strategy, JPMorgan Chase & Co.

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Question 1. At a recent CFTC Market Risk Advisory Committee meeting a number of buy-side witnesses testified that the practice of post-trade name-give up—that is: the removal of anonymity from the market after execution, has prevented them from participating in the SEFs offered by the Inter-Dealer Brokers. Further, two class-action lawsuits alleging anti-trust violations against the largest dealers and several of the interdealer brokers have been filed in the credit default swap and interest rate markets respectively. These suits both allege that the practice of post-trade name give-up has been planned by the largest participants and forced on to the inter-dealer brokers in restraint of trade. One of them settled late last year for $2bn.

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Do all eligible market participants have impartial access to each and every SEF? If not, why not?

Answer. Yes. All eligible market participants, as defined by each SEF, are given the same access. Each SEF is responsible for determining its own participation rules, which apply equally to sell-side and buy-side participants.

Question 2. There was a great deal of testimony regarding harmonization with European Rules. However, from published reports a number of trade organizations representing incumbent firms with significant market power have been arguing to European regulators and legislators to make changes to the proposed trade execution regime in MiFID II. If that effort is successful, we will be asked to harmonize, or to push the CFTC to harmonize, our clear rules on impartial access to the SEF marketplace for eligible participants with rules that include no such mandate. In that eventuality should harmonization still be our top priority?

Answer. As a general matter, global harmonization of rules is important to ensure well-functioning derivatives markets. We do not have a view as to how the Committee should prioritize the hypothetical situation identified.

Question 3. The swaps we discussed at the hearing are not customized—they are standardized. Standardized swaps are the only swaps that are subject to the trading mandate—they are cleared and are subject to the straight-through-processing requirement. And yet, we repeatedly hear that the swaps market is fundamentally different than other standardized markets: that it is characterized by episodic liquidity and that its bifurcated, two-tiered structure is the "natural" evolution of the market. Do you agree or disagree with that characterization?

Answer. There are fundamental differences between the swaps market and other standardized markets. For example, liquidity in swaps markets tends to be thinner and more episodic compared to the futures and equities markets. This episodic liquidity leads to differences in market structure and a broader range of methods of execution sought by market participants. The CFTC's rules set out minimum liquidation periods for initial margin levels that differ between swaps and futures (currently five days for most cleared swaps and one day for futures), demonstrating their own view that the liquidity profile of the products is different.

Question 4. In your testimony you both described the swaps market as being "fragmented" as a result of differences in cross-border regulatory progress, but you didn't identify who was responsible for that fragmentation. The latest OCC report on swaps trading finds that the four largest banks control 91% of the notional market. Are trading decisions at the firms with that much control of the market responsible for fragmentation? If not, who else is fragmenting it?

Answer. The four largest banks are not responsible for the fragmentation, and it would not be accurate to state that those banks control 91% of the notional market for swaps trading; the OCC report does not reflect the swaps flow executed by the banks. According to the latest research from the International Swaps and Derivatives Association (ISDA), the global interest rate swaps market has fragmented along jurisdictional lines since the US swap execution facility rules came into force in October of 2013. This fragmentation has been most pronounced in the euro-denominated interest rate swaps markets, where 91.2% of cleared euro IRS activity in the European interdealer market was transacted between European counterparties in December 2015. In September 2013, immediately prior to the introduction of the SEF rules, the figure stood at 70.7%.

This data is an indication that non-U.S. market participants are choosing to transact less with U.S. persons, or certain foreign subsidiaries or affiliates of U.S. persons, as such transactions would be required to be executed on SEF platforms.

Question 5. The CFTC has required trade data to remain anonymous at the SDR level. What do you feel the impact would be if the CFTC imposed a requirement that if a trade is entered anonymously it would need to stay anonymous throughout its life-cycle?

Answer. Venues exist today for anonymous trades to remain anonymous throughout their life cycle, and therefore there is not a need for the CFTC to mandate such a requirement. Markets function best with sound regulation, open competition and customer choice.

Question 6. We have rules in place to ensure a fair, anonymous, all-to-all swaps markets where multiple participants can make both bids and offers—that type of structure is much more balanced—and historically as we've seen with the futures and equity's markets, much more resilient in times of stress. Please comment on the structural stability that could be supplied if these markets truly operated in the anonymous all-to-all manner we intended?

Answer. We respectfully disagree with the two assumptions that underlie this question: (1) anonymous all-to-all swaps markets are "much more balanced" and more resilient in times of stress; and (2) swaps are similar to futures and equities (we refer you to our response to *Question 3*).

Avenues for anonymous all-to-all trading of swaps already exist alongside trading through Request-for-Quote (RFQ). Thus, customers have a choice between the two execution methods. Efficient and stable markets are best achieved through sound regulation and free and open competition.

Question 7. We wrote the SEF Core Principles to require impartial access, the CFTC's SEF rule requires impartial access and yet market participants don't have impartial access to the full market—what needs to change for all eligible market participants to have the kind of access we envisioned?

Answer. We refer you to our response to *Question 1.*

Response from Stephen M. Merkel, J.D., Executive Vice President, General Counsel and Secretary, BGC Partners, Inc.; Director, Wholesale Markets Brokers' Association, Americas

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Question 1. At a recent CFTC Market Risk Advisory Committee meeting a number of buy-side witnesses testified that the practice of post-trade name-give up—that is: the removal of anonymity from the market after execution, has prevented them from participating in the SEFs offered by the Inter-Dealer Brokers. Further, two class-action lawsuits alleging anti-trust violations against the largest dealers and several of the interdealer brokers have been filed in the credit default swap and interest rate markets respectively. These suits both allege that the practice of post-trade name give-up has been planned by the largest participants and forced on to the inter-dealer brokers in restraint of trade. One of them settled late last year for $2bn.

The SEF Core principles in Dodd Frank require impartial access for all eligible market participants. The CFTC's SEF Rule mandates that a SEF must ensure "impartial access to its markets and market services" for eligible participants—and that eligibility itself must be set in an impartial, transparent, fair and non-discriminatory manner.

Do all eligible market participants have impartial access to each and every SEF? If not, why not?

Answer. As envisioned by Congress, the SEF landscape is competitive, with over two dozen registered trading venues competing for liquidity and trading activity in the over-the-counter marketplace. The WMBAA member firms' SEFs are among those platforms. Each of these SEFs has demonstrated compliance with CFTC regulation 37.202(a) and has set forth clear criteria for market participants who wish to access its market and market services.

With any competitive marketplace, customers have the option to conduct business with an array of companies and different types of trading platforms. Very few market participants will engage with all 24 SEFs. For each SEF, eligible market participants have to review and compare individual execution models, rule books, analyze different cost structures, and consider the legal and technical components of onboarding when deciding whether to access a market. As the structure of the market evolves in the aftermath of the credit crisis and financial regulatory reform implementation, trading methodologies and structure will continue to evolve as well. True to the Dodd-Frank statutory intent, we look forward to continued competition among resilient, innovative trading venues to promote the trading of swaps through registered intermediaries.

Question 2. There was a great deal of testimony regarding harmonization with European Rules. However, from published reports a number of trade organizations representing incumbent firms with significant market power have been arguing to European regulators and legislators to make changes to the proposed trade execution regime in MiFID II. If that effort is successful, we will be asked to harmonize, or to push the CFTC to harmonize, our clear rules on impartial access to the SEF marketplace for eligible participants with rules that include no such mandate. In that eventuality should harmonization still be our top priority?

Answer. As noted in my testimony, OTC swap markets are global in nature. The WMBAA remains supportive of coordinated global efforts to promote trading on regulated venues, central counterparty clearing, and public reporting of standardized OTC derivative contracts in order to "improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse." [1]

In just the last few years, we have seen liquidity move across borders forming regional liquidity pools. Global regulators should carefully coordinate regulatory efforts so as to not fragment markets, reduce liquidity, and increase costs to users by rupturing the existing methods by which U.S. and non-U.S. swap dealers, international banks, global asset managers, and end-users access competitive, transparent OTC markets in the U.S. or in other jurisdictions. Global regulatory gaps have not only promoted bifurcation of trading patterns but can be exploited to the detriment of investors.

Question 3. The swaps we discussed at the hearing are not customized—they are standardized. Standardized swaps are the only swaps that are subject to the trading mandate—they are cleared and are subject to the straight-through-processing requirement. And yet, we repeatedly hear that the swaps market is fundamentally different than other standardized markets: that it is characterized by episodic liquidity and that its bifurcated, two-tiered structure is the "natural" evolution of the market. Do you agree or disagree with that characterization?

Answer. Yes, the swaps market is fundamentally different than other standardized markets. It is a wholesale market where institutional market participants can hedge risk exposures. Congress recognized the distinctions between exchange-traded financial products like futures and equities, on the one hand, and over-the-counter products such as swaps. The Dodd-Frank Act provides unique statutory provisions to preserve and enhance the unique liquidity characteristics, institutional nature of market participants, and bespoke nature of many of the instruments.

As referenced in my testimony, a 2011 Federal Reserve Bank of New York (FRBNY) report found that the vast majority of single-name credit default swap (CDS) contracts traded less than once per day and index CDS contracts traded less than ten times per day, but in very large sizes. Similarly, the vast majority of interest rate swap contracts traded only once during the 3 month period studied. In comparison, many more exchange-traded products tend to have continuous liquidity. Certain Eurodollar futures contracts trade on the Chicago Mercantile Exchange (CME) over 375,000 times per day.

The FRBNY study affirms that there are different levels of liquidity in the marketplace, even among "standardized" products. This is why Dodd-Frank correctly ensured flexibility in how market participants can meet the trading mandate and transact "through any means of interstate commerce."

We support revising the CFTC's swap rules to bring them more in line with the statutory intent of Dodd-Frank to "promote SEF trading" and also to ensure that the global OTC swap market is made more competitive and resilient, all while protecting the unique market structure that continues to evolve over time.

Question 4. In your testimony you both described the swaps market as being "fragmented" as a result of differences in cross-border regulatory progress, but you didn't identify who was responsible for that fragmentation. The latest OCC report on swaps trading finds that the four largest banks control 91% of the notional market. Are trading decisions at the firms with that much control of the market responsible for fragmentation? If not, who else is fragmenting it?

Answer. As I noted in my testimony, fragmentation is driven by the CFTC's SEF rules and the lack of regulatory harmonization with respect to permitted modes of trade execution. Anecdotally, we have seen market participants refrain from transacting with counterparties in certain jurisdictions to avoid the CFTC's regulatory burdens. As a result, liquidity has formed by jurisdiction. Trading has become more regionalized with Asian, European and U.S. counterparties trading in separate jurisdictions and with a reduced number of potential counterparties. My testimony cites to recent ISDA and Bank of England research supporting these observations.

[1] See Leaders' Statement, the Pittsburgh Summit, September 24–25, 2009, available at *https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf*.

We have concerns that these regulatory gaps will have a more pronounced effect as we approach the impending MiFID II January 2018 target compliance date. These differences must be resolved as soon as possible. We urge the Subcommittee to prioritize execution equivalence and global coordination as the primary tool to counter the increasingly well-entrenched trend for liquidity to be split along regional lines.

Question 5. The CFTC has required trade data to remain anonymous at the SDR level. What do you feel the impact would be if the CFTC imposed a requirement that if a trade is entered anonymously it would need to stay anonymous throughout its life-cycle?

Answer. I cannot speculate on the possible market structure impact this requirement may have if imposed. However, I strongly encourage the CFTC—for this or any other policy proposal—to engage in data-driven analysis based on timely, accurate information, to quantify the costs and benefits of its proposals. These proposals should be published in the *Federal Register* for an appropriate public notice and comment period. These procedural protections will help to produce the soundest policy and reflect the input of market participants.

The CFTC is the beneficiary of several years of comprehensive swap market data through SDR reporting. The Commission should closely consider the value of this information and perform a rigorous review of the information in light of its policy initiatives. As I said at the hearing, if ISDA and the Bank of England can conduct research and publish their findings for public review, the CFTC should too.

Question 6. We have rules in place to ensure a fair, anonymous, all-to-all swaps markets where multiple participants can make both bids and offers—that type of structure is much more balanced—and historically as we've seen with the futures and equity's markets, much more resilient in times of stress. Please comment on the structural stability that could be supplied if these markets truly operated in the anonymous all-to-all manner we intended?

Answer. Please see my response to *Question 5.*

Question 7. We wrote the SEF Core Principles to require impartial access, the CFTC's SEF rule requires impartial access and yet market participants don't have impartial access to the full market—what needs to change for all eligible market participants to have the kind of access we envisioned?

Answer. Please see my response to *Question 1.*

Response from Stephen John Berger, Director, Government and Regulatory Policy, Citadel, LLC; on behalf of Managed Funds Association

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Question 1. At a recent CFTC Market Risk Advisory Committee meeting a number of buy-side witnesses testified that the practice of post-trade name-give up—that is: the removal of anonymity from the market after execution, has prevented them from participating in the SEFs offered by the Inter-Dealer Brokers. Further, two class-action lawsuits alleging anti-trust violations against the largest dealers and several of the interdealer brokers have been filed in the credit default swap and interest rate markets respectively. These suits both allege that the practice of post-trade name give-up has been planned by the largest participants and forced on to the inter-dealer brokers in restraint of trade. One of them settled late last year for $2bn.

The SEF Core principles in Dodd Frank require impartial access for all eligible market participants. The CFTC's SEF Rule mandates that a SEF must ensure "impartial access to its markets and market services" for eligible participants—and that eligibility itself must be set in an impartial, transparent, fair and non-discriminatory manner.

Do all eligible market participants have impartial access to each and every SEF? If not, why not?

Answer. The CFTC provided additional clarity regarding the Dodd-Frank Act's impartial access requirement in the final SEF rules and in subsequent impartial access guidance issued in November 2013. This additional guidance from the CFTC has been critical in dismantling certain barriers that prevented market participants from accessing certain trading venues for OTC derivatives, such as restrictive access criteria that limited membership only to banks.

However, we believe that barriers still remain that prevent buy-side market participants from fully interacting on each and every SEF in the market. One such significant barrier is the continued use of post-trade name give-up by the legacy interdealer SEFs. By revealing counterparty identities post-trade to a swap that was initially executed anonymously, these legacy interdealer SEFs inhibit buy-side participation even though buy-side participants are now theoretically able to join these trading venues.

The practice of post-trade name give-up originated in uncleared markets, where counterparties needed to know each other's identity in order to properly book and risk manage the swap. However, for cleared swaps that are executed anonymously, we believe that there is no legitimate reason that one party needs to find out the identity of the other party post-trade, given that both parties immediately face the clearinghouse and do not have any bilateral counterparty credit exposure to each other. If two parties agree to execute anonymously, this choice should be respected throughout the life cycle of the swap.

Post-trade name give-up inhibits buy-side participation on legacy interdealer SEFs in several ways. First, post-trade name give-up is a source of random and uncontrolled "information leakage" of private trading positions and strategies, given that participants are not able to control who they may be matched with when executing anonymously on the SEF. Second, post-trade name give-up perpetuates the informational and trading advantages of traditional dealers that benefit from their ability to access and achieve full visibility into both the inter-dealer and dealer-to-customer markets. In many cases, buy-side participants are discouraged from ever even beginning to trade on these legacy interdealer SEF platforms as long as the practice continues.

MFA therefore believes that impartial access to SEFs will only be realized once post-trade name gave-up is prohibited for all anonymously-executed cleared SEF trades.

Question 2. There was a great deal of testimony regarding harmonization with European Rules. However, from published reports a number of trade organizations representing incumbent firms with significant market power have been arguing to European regulators and legislators to make changes to the proposed trade execution regime in MiFID II. If that effort is successful, we will be asked to harmonize, or to push the CFTC to harmonize, our clear rules on impartial access to the SEF marketplace for eligible participants with rules that include no such mandate. In that eventuality should harmonization still be our top priority?

Answer. In MFA's view, ensuring impartial access to trading venues is critical in the continued implementation of the G20 reforms for the swaps markets. MFA believes that U.S. and European regulators should push for harmonization with respect to the implementation of impartial access requirements for trading venues and that this is an achievable, mutually beneficial priority that will benefit the long-term health and vitality of the global swaps markets.

Similar to the U.S. impartial access requirement, the European MiFID II legislation requires trading venues to provide non-discriminatory access to market participants (see Article 18(3) of the MiFID II Directive governing multilateral trading facilities (MTFs) and organized trading facilities (OTFs), and Article 53(1) of the MiFID Directive [1] governing regulated markets). As such, there should be no difference between the two regimes on this topic, though European regulators may be required to issue additional guidance (similar to the CFTC's November 2013 impartial access guidance) in order to ensure that the non-discriminatory access requirement is properly implemented. We believe that ensuring equivalent standards with respect to the implementation of impartial access should be a key focus in future discussions regarding harmonization and regulatory equivalence.

Question 3. The swaps we discussed at the hearing are not customized—they are standardized. Standardized swaps are the only swaps that are subject to the trading mandate—they are cleared and are subject to the straight-through-processing requirement. And yet, we repeatedly hear that the swaps market is fundamentally different than other standardized markets: that it is characterized by episodic liquidity and that its bifurcated, two-tiered structure is the "natural" evolution of the market. Do you agree or disagree with that characterization?

Answer. MFA disagrees with that characterization for standardized and liquid cleared swaps. While more bespoke customized swaps may trade relatively infrequently, experience with the reforms in the U.S. has shown that a great many cleared swaps are standardized and highly liquid, and are suitable for SEF trading. In fact, recent Bank of England research found that the implementation of the clear-

[1] Directive 2014/65/EU of The European Parliament and of the Council of 15 May 2014 on markets in financial instruments, available at *http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32014L0065*.

ing and trading reforms in the USD interest rate swaps market has already yielded significant improvements in pricing and liquidity for investors.[2]

As such, MFA does not believe that the current bifurcated, two-tiered market structure is the "natural" evolution of the market. The two-tier structure impairs pre-trade transparency for buy-side market participants and prevents buy-side market participants from accessing important sources of liquidity in the marketplace. This two-tier structure also confines the buy-side to a "price-taker" role, rather than providing the opportunity to become a "price-maker" as well, and can impair price discovery and competition. In MFA's view, the two-tier market needs to evolve in order to improve competition and market liquidity, and fully implementing the Dodd-Frank Act's impartial access requirement is critical to allowing this evolution to occur.

Question 4. The CFTC has required trade data to remain anonymous at the SDR level. What do you feel the impact would be if the CFTC imposed a requirement that if a trade is entered anonymously it would need to stay anonymous throughout its life-cycle?

Answer. In MFA's view, the imposition of such a requirement would be consistent with prior CFTC rulemaking to ensure that trade data remains anonymous at the SDR level. Currently, this CFTC rule is undermined by the continued use of post-trade name give-up, as a counterparty can find out the identity of the other party to a trade from the SEF even though they are prohibited from doing so at the SDR. If two parties agree to execute anonymously, this choice should be respected throughout the life cycle of the swap.

As stated above, MFA believes that ending the practice of post-trade name give-up for anonymously executed cleared swaps will lead to more buy-side participation on legacy interdealer SEFs. In our view, impartial access requirements have contributed to healthy liquidity conditions in several other significant markets, such as the equities and futures markets. Based on these examples, MFA believes that true impartial access will provide a stronger foundation for U.S. swaps market liquidity and enhance price transparency and competition in the U.S. swaps market.

Question 5. We have rules in place to ensure a fair, anonymous, all-to-all swaps markets where multiple participants can make both bids and offers—that type of structure is much more balanced—and historically as we've seen with the futures and equity's markets, much more resilient in times of stress. Please comment on the structural stability that could be supplied if these markets truly operated in the anonymous all-to-all manner we intended?

Answer. Fully implementing and enforcing the Dodd-Frank Act's impartial access requirement would allow an all-to-all market for cleared swaps to emerge (where multiple market participants are able to meet and transact). In our view, an all-to-all market has contributed to healthy liquidity conditions in several other significant markets, such as the equities and futures markets.

By contrast, the current bifurcated two-tier swaps market structure entrenches traditional dealers as exclusive "price makers". It also limits the manner and extent to which buy-side participants may interact in the swaps market. Such structural limitations on liquidity provision and risk transfer may increase the likelihood of market volatility and instability over the long term. The willingness and capacity of traditional dealers to allocate balance sheet to swaps market-making activities appears to be diminishing in certain respects. This trend will likely continue over time as traditional dealers continue to restructure their businesses post-financial crisis and adapt to new capital, leverage, and liquidity requirements under Basel III and similar rules. Without swaps market reforms that facilitate impartial access to all SEFs and encourage alternative forms of price formation and liquidity provision and greater diversity of participation (among participants and modes of interaction), MFA fears that the U.S. swaps market could risk greater volatility and dislocation in times of market stress.

Question 6. We wrote the SEF Core Principles to require impartial access, the CFTC's SEF rule requires impartial access and yet market participants don't have impartial access to the full market—what needs to change for all eligible market participants to have the kind of access we envisioned?

Answer. MFA would encourage the CFTC to take action to prohibit the use of post-trade name give-up for cleared swaps executed anonymously on SEFs. MFA has submitted a petition to the CFTC in this regard and is hopeful this prohibition

[2] See Staff Working Paper No. 580 "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act", Bank of England (January 2016), available at: *http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf*.

will be included in any proposed modifications to the SEF rules. Without CFTC action, commercial dynamics make it difficult for any one legacy interdealer SEF to unilaterally stop using post-trade name give-up while others still do.

In addition, MFA would encourage the CFTC to prioritize the enforcement of impartial access. It would be useful for the CFTC to actively monitor the progress of trading reforms in the swaps markets, and what barriers may continue to affect participation and trading activity. We also continue to urge the CFTC to finalize dealer ownership and governance restrictions for SEFs, as otherwise potential conflicts of interest could arise that inhibit natural market structure evolution.

Response from Luke D. Zubrod, Director, Risk and Regulatory Advisory Services, Chatham Financial

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Do all eligible market participants have impartial access to each and every SEF? If not, why not?

Answer. The segment of the market Chatham Financial serves has not had difficulty accessing SEFs. Chatham's clients are end users, and generally use SEFS to hedge interest rate risk. Thus, we are not in a position to offer expert insight into the nature of access in the credit default swap market. End-users generally use derivatives to manage and reduce risk (*i.e.,* to hedge)—not for speculative or trading purposes. Those that use derivatives to hedge, generally rely on SEFs that price transactions via the request for quote (*i.e.,* RFQ) model because it permits greater flexibility to structure a hedge to offset a firm-specific risk. While hedgers and those using derivatives for investment purposes alike could make use of central limit order books (*i.e.,* CLOB)—the pricing model in which Inter-Dealer Brokers excel—the RFQ model in which Inter-Dealer Brokers do not play a significant role is, in our view, best suited for end-user hedgers.

Buy side asset managers use derivatives for both hedging and investment purposes; thus, the optimal execution method—whether RFQ or CLOB—may differ from those of other kinds of financial end users, such as those whom we advise and on whose behalf we transact. As a general principle, Chatham appreciates the value of anonymous trading and we do not see a benefit to most end-users of name-disclosed approaches. However, our experience does not allow us to offer material input on the question of access to the central limit order books offered by Inter-Dealer Brokers.

Question 2. There was a great deal of testimony regarding harmonization with European Rules. However, from published reports a number of trade organizations representing incumbent firms with significant market power have been arguing to European regulators and legislators to make changes to the proposed trade execution regime in MiFID II. If that effort is successful, we will be asked to harmonize, or to push the CFTC to harmonize, our clear rules on impartial access to the SEF marketplace for eligible participants with rules that include no such mandate. In that eventuality should harmonization still be our top priority?

Answer. Chatham sees growth in electronic trading in the OTC derivatives market as a positive development. This growth has been spurred both by technological advancement and by regulatory mandates in the U.S. and Europe. The principle benefits of electronic trading are the ease of facilitating competition and the benefits of straight through processing, especially where a party transacts in high volumes. These benefits must be set against the costs of evaluating electronic marketplaces, reviewing rulebooks of those marketplaces, and setting up systems to facilitate straight-through processing. Transaction volumes will often dictate whether the benefits of electronic trading outweigh the costs. Those that transact in high volumes will generally see benefits in adopting electronic trading and will often choose to transact electronically whether or not regulation requires them to do so.

Chatham believes it is not necessary to tightly prescribe protocols by which electronic marketplaces operate. The U.S. has generally taken a more prescriptive approach relative to Europe with respect to trading protocols imposed on SEFs. For example, U.S. regulations require that a minimum number of dealers participate in swap auctions via electronic marketplaces, while requirements on European trading platforms are subject to lower requirements. We believe the benefits of competition and straight-through processing can accrue under various protocols and rule sets, and that the prescriptive approach adopted by the U.S. is not necessary to ensure a competitive marketplace.

As a general principle, we believe it beneficial to market participants when regulators globally coordinate and harmonize their rules—both with respect to their content and timing—and we believe such efforts with respect to trading rules should be given due consideration.

Question 3. The swaps we discussed at the hearing are not customized—they are standardized. Standardized swaps are the only swaps that are subject to the trading mandate—they are cleared and are subject to the straight-through-processing requirement. And yet, we repeatedly hear that the swaps market is fundamentally different than other standardized markets: that it is characterized by episodic liquidity and that its bifurcated, two-tiered structure is the "natural" evolution of the market. Do you agree or disagree with that characterization?

Answer. Yes. Bilateral, uncleared swaps (*i.e.,* typically customized swaps) play an important role in allowing market participants to manage risk. When risk management is the objective, such swaps are generally superior to standardized swaps which cannot be customized to perfectly offset idiosyncratic risks. Absent customized swaps, market participants would be forced to retain risks that they might otherwise have been able to transfer. In addition to the economic benefits of customization, market participants who perfectly match their hedge to their risk achieve accounting results—via hedge accounting treatment—that are more consistent with the economic outcome achieved through hedging. That is, income statement volatility is reduced or eliminated in line with the risk reducing nature of the hedges.

Additionally, bilateral, uncleared swaps permit customization with respect to the credit arrangements used to manage risk associated with the swap. Just as banks are able to accept various forms of collateral with respect to loans, end-users value their ability with bilateral, uncleared swaps to customize the credit support arrangements they enter into with swap dealers. For example, centrally cleared swaps are secured by initial and variation margin. While bilateral, uncleared swaps may be similarly secured, end users may negotiate credit support arrangements that are better tailored to their needs. For example, a real estate firm may grant a security interest in a real estate asset to its swap counterparty, who also may serve as lender on loan that the swap hedges. Real estate firms, among others, own physical assets and do not carry significant amounts of cash greatly benefit from such customizable credit arrangements.

At the same time, firms that transact in significant volumes, have low cost of capital and ready access to liquid resources (*e.g.,* cash and certain securities) may find that the centrally cleared market meets their risk management needs. Such participants may prefer the risk management characteristics of a centralized market.

Thus, we believe a two-tiered market benefits the market and is not inconsistent with public policy objectives related to systemic risk and transparency.

Question 4. The CFTC has required trade data to remain anonymous at the SDR level. What do you feel the impact would be if the CFTC imposed a requirement that if a trade is entered anonymously it would need to stay anonymous throughout its life-cycle?

Answer. We believe it appropriate that regulators implement rules in a manner that prevents market participants from having visibility into an individual company's positions. However, we believe it appropriate for regulators to have such visibility with respect to all positions.

Question 5. We have rules in place to ensure a fair, anonymous, all-to-all swaps markets where multiple participants can make both bids and offers—that type of structure is much more balanced—and historically as we've seen with the futures and equity's markets, much more resilient in times of stress. Please comment on the structural stability that could be supplied if these markets truly operated in the anonymous all-to-all manner we intended?

Answer. We believe that structural stability can be supplied to these markets without an all-to-all market. Indeed, we believe the principle contribution of an all-to-all model in the derivatives market relates more to transparency than it does systemic stability, and even the transparency benefits can be achieved in ways that are less prescriptive than a mandated all-to-all market structure. We believe other mechanisms can adequately address systemic stability concerns, including clearing, margin and capital requirements. In essence, we think while there may be benefits in some cases for all-to-all markets, we do not believe there are sufficient benefits to justify that such a structure be mandated. Indeed, we believe end-user risk management objectives are furthered by way of a variety of means of execution.

Question 6. We wrote the SEF Core Principles to require impartial access, the CFTC's SEF rule requires impartial access and yet market participants don't have impartial access to the full market—what needs to change for all eligible market participants to have the kind of access we envisioned?

Answer. As noted, Chatham's experience - principally focused on interest rate markets and the RFQ model—does not suggest a significant concern with impartial access to SEFs. Nonetheless, we think it not inappropriate for policy makers to carefully consider the concerns of market participants transacting in other asset classes (*e.g.,* credit default swaps) and other execution methods (*e.g.,* central limit order books).

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