Crapo Opening Statement on Swap Execution Facilities Hearing:

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

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

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

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

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

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

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

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

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

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

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

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

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

Stephen Merkel

Executive Vice President and General Counsel
BGC Partners, Inc.

Representing the Wholesale Markets Brokers' Association - Americas

Before the Senate Subcommittee on
Securities, Insurance, and Investment

June 29, 2011

Testimony of Stephen Merkel

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

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

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

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

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

- **Readiness.** In terms of readiness, BGC and its fellow WMBAA member firms are currently fully functional as market intermediaries in the OTC derivatives markets and will be ready to initiate SEF operations on *day one*. Wholesale brokers are today's central

[1] BGC Partners, Inc. (NASDAQ: BGCP) (www.bgcpartners.com) is a leading global intermediary to the wholesale financial markets, specializing in the brokering of a broad range of financial products including fixed income, rates, foreign exchange, equities, equity derivatives, credit derivatives, futures and structured product markets. BGC offers a full range of brokerage services including price discovery, trade execution, straight through processing and clearing, settlement and access to electronic trading services through its eSpeed, BGC Trader and BGC Pro brands. On April 1, 2008, BGC merged with eSpeed to form a world-class provider of voice and electronic brokerage services in the global marketplace. The combined company is BGC Partners, Inc. Since its separation from Cantor Fitzgerald in 2004, BGC has expanded to 24 offices worldwide with over 1700 brokers and approximately 2700 employees. In 2005, BGC merged with Maxcor Financial Group, integrating two leading brokerage firms. This was followed by the acquisitions of ETC Pollak and Aurel in Paris.

[2] The WMBAA is an independent industry body representing the largest interdealer brokers operating in the North American wholesale markets across a broad range of financial products. The WMBAA and its member firms have developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets*. Using these *Principles* as a guide, the WMBAA seeks to work with Congress, regulators, and key public policymakers on future regulation and oversight of institutional markets and their participants. By working with regulators to make wholesale markets more efficient, robust and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country's capital markets. The five founding members of the WMBAA are BGC Partners; GFI Group; ICAP; Tradition and Tullett-Prebon. More about the WMBAA can be found at: www.WMBAA.org.

marketplaces in the global swaps markets and, as such, can serve as a prototype for prospective independent and competitive SEFs.

- **Voice and electronic modes of trade execution.** Wholesale brokers are experts in fostering liquidity and transparency in global swaps markets by utilizing trade execution methodologies that feature a hybrid blend of knowledgeable and qualified brokers, as well as sophisticated electronic technology. The CFTC's proposed rules are inconsistent with the statute in the way that they limit how trades are executed, most particularly in how they limit trades that occur utilizing voice or telephonic communication. Such a limitation is inconsistent with the statute's clear language that ensures that SEFs can utilize "any means of interstate commerce." The SEC's proposed rule is much more flexible and consistent with the statute.

- **Block trade size and preserving liquidity and anonymity in the market**. Liquidity in today's swaps markets is fundamentally different than liquidity in futures and equities markets, and the unique characteristics of this liquidity are what naturally determine the optimal mode of market transparency and trade execution. The CFTC's proposal could jeopardize liquidity in the markets by relying on inappropriate factors to determine a block trade. This would harm the ability of investors to manage large positions, impact the ability of counterparties to engage in anonymous price discovery and, ultimately, increase the cost of risk management to end users. The definition of block trade must be based on hard market data to minimize unintended negative consequences.

- **Competition.** It is vital that the rules be consistent with the clear and unambiguous provisions in the statute ensuring that clearinghouses provide SEFs "nondiscriminatory access" to clearing. To be consistent with the statute this must include direct and indirect actions that not only inhibit access to clearing, but also actions that would bundle the services of a clearinghouse that operates an execution facility (exchange or SEF), thereby providing favorable treatment to their own affiliates over their independent competitors. Another form of discrimination includes treating differently SEF traded contracts and those traded on exchanges in liquidation. The CFTC's proposed rule needs to be changed to ensure that in liquidation there is identical treatment of the cleared contract regardless of the venue it traded.

Essential Elements that Regulators Need to Get Right under Title VII

- The final regulations enacted by the Commodity Futures Trading Commission ("CFTC" or "Commission") and Securities and Exchange Commission ("SEC" or "Commission" and, together with the CFTC, the "Commissions") must be consistent with the plain language of Dodd-Frank and allow for multi-modes of execution as Congress intended. SEFs must not be restricted from deploying the many varied and beneficial trade execution methodologies and technologies successfully used today to execute swaps transactions.

- There must be harmonization between the CFTC and SEC, as well as consistency in international regulation.

- New regulations must be phased-in appropriately to prevent unnecessary disruption to the markets.

- Regulators must use a flexible approach to SEF registration, permitted modes of trade execution and impartial access. Regulations should support the formation of a common regulatory organization ("CRO") for SEFs to implement and facilitate compliance with the Commissions' rules. The CRO would ensure that a single, consistent standard is applied across multiple SEFs and prevent a "race to the bottom" for rule compliance and enforcement programs.

Background on Wholesale Brokers

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

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

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

Increasingly, the efficiencies of the market have inevitably led to a demand for better trading technology. To that end, we develop and deploy sophisticated trade execution and support technology that is tailored to the unique qualities of each specific market. For example, BGC's customers in certain of our more complex, less commoditized markets may choose among utilizing our electronic brokerage platforms to trade a range of fixed income

derivatives, interest rate derivatives, foreign exchange options, repurchase agreements and energy derivatives entirely on screen. Alternatively, they can execute the same transaction through instant messaging devices or over the telephone with qualified BGC brokers supported by sophisticated electronic technology. It is important to note that the migration of certain products to electronic execution was not, and has never been, because of a regulatory or legal mandate but simply part of the natural evolution and development of greater market efficiencies in particular markets. Conversely, the persistence of customer preference for trade execution through telephonic communications for certain products, despite the apparent efficiencies associated with electronic trading in other similar products in the same markets, reflects those customers' preference for the unique advantages that "voice" brokers can provide in liquidity formation with respect to less-liquid or more bespoke products.

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

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

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

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

In enacting these structural changes, DFA wisely rejected the anticompetitive, single silo exchange model of the futures industry, in which clearing and execution are intertwined, thereby giving the exchange an effective execution monopoly over the products that it

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

clears.[4] Rather, by requiring central clearing counterparties to provide non-discriminatory access to unaffiliated execution facilities, DFA promotes a market structure in which competing SEFs and exchanges will vigorously compete with each other to provide better services at a lower cost in order to win the execution business of sophisticated market participants. In this regard, DFA preserves the best competitive element in the existing swaps landscape: competing wholesale brokers.

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

Critical Elements to Get Right

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

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

1. Permitted Modes of Execution

As previously stated, DFA defines SEFs as utilizing "any means of interstate commerce" to match swaps counterparties. This is an appropriate allowance by Congress, as the optimal means of interaction in particular swaps' markets varies across the swaps landscape. Congress recognized that it was best left to the marketplace to determine the best modes of

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

execution for various swaps and, thereby, foster technological innovation and development. Congress specifically did not choose to impose a federally mandated "one-size-fits-all" transaction methodology on the regulated swaps market.

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

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

Permitted Use of Voice and Hybrid Trade Execution Platforms

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

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

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

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

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

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

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

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

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

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

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

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

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

3. Implementation of Final Rules

Compliance Timeline

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

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

Appropriate "Phasing" of Final Rules

Based upon the plain language of Dodd-Frank, the mandatory trade execution requirement will become effective at the time that swaps are deemed "clearable" by the appropriate Commission. Accepting the premise that the mandatory trade execution requirement cannot be enforced until there are identified "clearable" swaps and swaps are "made available for trading," the Commissions need to ensure that a functioning and competitive marketplace of registered SEFs exists at the time the first trade is cleared and made available for trading. As

such, it is necessary that SEFs be registered with the CFTC or SEC, as applicable, and available to execute transactions at the time that trades begin to be cleared under the new laws. As stated previously, the WMBAA estimates that its members currently account for over 90% of inter-dealer intermediated swaps transactions taking place around the world today. If the SEF registration process is not effectively finalized by the time various swaps are deemed clearable, there could be serious disruptions in the U.S. swaps markets with adverse consequences for broader financial markets.

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

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

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

- First, finalize product definitions. Providing the market with certainty related to the scope of what constitutes a "swap" and "security-based swap" will allow market participants to accurately gauge the impact of the other proposed rules and provide constructive feedback on those rules.

- Second, implement final rules related to real-time reporting for regulatory oversight purposes. The submission of information to SDRs is an activity that takes place in many OTC markets today and will not unduly burden those who must comply with the requirement. Ensuring that the Commissions receive current, accurate market data is a cost-effective method to mitigate systemic risk in the short-term.

- Next, establish block trade thresholds and finalize public reporting rules. The information gathered by SDRs since the implementation of the mandatory trade

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

reporting requirement, along with historical data made available by trade repositories and trade execution facilities, can be used to determine the appropriate threshold levels on a product-by-product basis. At the same time, public reporting rules can be put into place, including an appropriate time delay (that is consistent with European and the other major global market rules) for block trades.

- After the reporting mechanics have been established, the clearing mandate can be implemented. During this step, the Commissions can determine what swaps are "clearable" and subject to the clearing mandate, and clearinghouses can register and begin to operate within the new framework.

- Finally, once swaps are deemed clearable, the mandatory trade execution requirement can be put into place for SEFs and DCMs for those products made available for trading. All clearable swaps will be made available for trading by SEFs, as these trade execution platforms compete to create markets and match counterparties. With the trade execution requirement's implementation, it is imperative that rules for SEFs and DCMs are effective at the same time, as implementing either entity's rules prior to the other will result in an unfair advantage for capturing market share of executable trades simply because they could more quickly meet the regulatory burdens.

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

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

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

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

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

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

Impartial Access to SEFs

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

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

Regulations Should Not Favor Execution on Particular Venues

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

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

The WMBAA believes that this disparity is ill-founded. In the case of two economically identical instruments - one executed on a SEF and one executed on a DCM - the liquidation

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

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

Interim or Temporary SEF Registration

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

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

The 15 Second Rule

There does not appear to be any authority for the CFTC's proposed requirement that, for "Required Transactions," SEFs must require that traders with the ability to execute against a customer's order or execute two customers against each other be subject to a 15 second timing delay between the entry of those two orders ("15 Second Rule"). One adverse impact of the proposed 15 Second Rule is that the dealer will not know until the expiration of 15 seconds whether it will have completed both sides of the trade or whether another market participant will have taken one side. Therefore, at the time of receiving the customer order, the dealer has no way of knowing whether it will ultimately serve as its customer's principal

counterparty or merely as its executing agent. The result will be greater uncertainly for the dealer in the use of its capital and, possibly, the reduction of dealer activities leading, in turn, to diminished liquidity in and competitiveness of U.S. markets with costly implications for buy-side customers and end users.

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

Ensuring that Block Trade Thresholds are Appropriately Established

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

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

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

As a result of the episodic nature of liquidity in certain swaps markets combined with the presence of fewer participants, I and my fellow WMBAA members believe that the CFTC and SEC need to carefully structure a clearing, trade execution and reporting regime for block trades that is not a "one size fits all" approach, but rather takes into account the

unique challenges of fostering liquidity in the broad range of swaps markets. Such a regime would provide an approach that permits the execution of transactions of significant size in a manner that retains incentives for market participants to provide liquidity and capital without creating opportunities for front-running and market distortion.

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

Bloomberg

Bloomberg L.P. 731 Lexington Avenue Tel +1 212 318 2000
New York, NY 10022 bloomberg.com

Testimony of

Ben Macdonald,

Global Head of Fixed Income,

Bloomberg, LP

Before a hearing of the Senate Banking Subcommittee on Securities, Insurance and Investment

re: "Emergence of Swaps Execution Facilities: A Progress Report"

June 29, 2011

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

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

I lead Bloomberg's team of professionals dedicated to establishing a registered Swaps Execution Facility (SEF) and Security-Based Swaps Execution Facility (SB-SEF)

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

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

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

Bloomberg's existing electronic swaps platforms: experience and innovative leadership

Our views on the subject of SEF[2] regulation are significantly informed by our long and successful experience derived from our existing OTC swaps trading platforms. We believe that body of expertise and experience provides Bloomberg the opportunity to

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

engage the new world of SEF registration and operation from a considerable position of strength. Our current OTC derivatives trading platforms were built on the idea of adding transparency to the market by creating electronic functions that streamline trading in swaps and provide efficient, competitive access to swaps pricing, all of which aligns very well with the goals of Title VII of Dodd-Frank.

Bloomberg's current "single-dealer" and "multi-dealer" derivatives trading tools allow multiple participants to view and trade swaps with multiple dealers. In Bloomberg's single-dealer page system, enabled participants are readily able to view different dealer pages (simultaneously if preferred) that display the price and volume at which each dealer has indicated it will trade. After reviewing the displayed prices a participant can then request to execute against a single-dealer page's displayed price with the understanding that the dealer can accept, counter or reject execution. Multi-dealer pages display a "composite price" reflecting the general market based on participating dealers' respective price submissions. After reviewing the displayed "composite price" a participant can request specific prices from 3 dealers. The participant then has a limited time to accept or reject a trade with any of the dealers. Under both models, Bloomberg provides real-time trade reporting to warehouses, data repositories and clearing venues.

Bloomberg also has hosted various "request for quote" (RFQ) systems for OTC derivatives for the past five years. These RFQ systems allow entities seeking liquidity to secure bids and offers from particular market participants they would like to engage in a transaction. Our Bloomberg Bond Trader System, a competitive multi-dealer RFQ platform for US and foreign government securities, has been active for more than 13 years. We are confident that these very successful RFQ models provide directly relevant

experience and are the proper conceptual paradigm for establishing a SEF under Dodd-Frank.

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

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

Responses to the Committee's Specific Areas of Inquiry:

Bloomberg most certainly supports Dodd-Frank's call for the emergence of SEF-style trading, increased mandatory clearing and post-trade transparency through reporting. In particular, Bloomberg is very supportive of the federal regulators providing clear and specific rules for clearing and post-trade transparency, which together serve as the most significant tools for reducing systemic risk and attaining a reformed, financially sound derivatives marketplace that benefits market participants and the nation as a whole.

The systemic risk threats that arose in 2008-2009 were associated with insufficient clearing and post-trade transparency and were not the result of execution failures. Indeed, market participants know very well what they want and need regarding fair and efficient execution on electronic platforms. Sophisticated market participants do not really need or want federal regulators micro-managing execution protocols; no one should expect that market participants will necessarily want to trade the way the federal government prefers that they trade. It is also not the proper role of the federal regulators to go to extravagant lengths to define the most favorable terms of execution for trading by sophisticated investors. Rather, while it is clearly a very important function, what is incumbent on federal regulators is only to insure that the market is fair and competitive and that participants themselves have enough information to assess whether they know that they are getting a fair price.

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

Consequently, we do not believe that the same degree of regulation warranted for clearing and post-trade reporting is desirable from a public policy perspective with regard to trade execution protocols. Rather, in providing rules on trading protocols, federal

regulators should specifically avoid over-regulation and imposing "one size fits all" mandates, but should instead use a principles-based approach which encourages flexibility by SEFs that will maximize their innovation, competition and responsiveness to the needs of the market. Failure to invest SEFs with the ability to employ flexibility in their trade execution protocols actually jeopardizes the realization of the public policy objectives that Dodd-Frank seeks to attain.

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

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

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

participants and products ought to play a significant role in that phasing/sequencing determination.

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

We further note that if "readiness" is viewed from the perspective of the state of the legal framework for the clearing and increased transparency imposed by Dodd-Frank for SEF trading, there is considerable work still ahead for the industry. Clearing and transparency are certainly priority objectives of Dodd-Frank's SEF regime as means to mitigate systemic risk, but those rules have not yet been articulated in final form by the CFTC and SEC. We expect those rules, once promulgated in final form, will be novel in many ways and costly, and it will take time for market participants to do all the things necessary to accommodate those rules in terms of legal documentation, installation of technology, and other critical responses. With regard to documentation alone, there is a significant number of necessary items that will require time for negotiation between

interested parties and for careful drafting by lawyers.[3] Ultimately, how much swaps trading moves to SEF platforms will be influenced by the complexity of the agencies' final rules and the cost of those rules for clearing, documentation, reporting and the like that must be borne by SEFs and their customers. The objective of those rules should be to minimize their cost and complexity in order to incentivize optimal movement of swaps trading to properly regulated SEF platforms and to minimize avoidance of those newly regulated SEF platforms.

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

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

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

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

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

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

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

- **Micro-management and over-regulation of trading protocols**:

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

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

Liquidity providers responding to a block trade RFQ need to factor in the size of the trade when quoting a price. Imposing a trading protocol that could materially alter the size of a block trade would inject uncertainty for the liquidity provider responding to

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

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

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

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

- **Cost of Compliance:**

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

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

Costs can further be reduced by providing a robust opportunity for SEFs to contract with third party service providers for such things as market surveillance, trade practice surveillance, real-time market monitoring, investigations of possible rule violations and disciplinary actions. In contracting for such services—while maintaining

Dodd-Frank's requirement that SEFs retain full, ultimate responsibility for decision making involving those functions—SEFs can avoid the capital and operational costs of creating the infrastructure of those functions for themselves internally and thereby reduce both the cost of entry into the SEF market and the cost of ongoing SEF operations.

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

- **Governance constrictions**:

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

Requiring all SEFs to meet these ownership and governance constrictions is a serious and unnecessary barrier to entry in the case of SEFs whose ownership structure

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

- **Extraterritoriality and International Harmonization**:

The swaps marketplace is a global business. A large percentage of transactions on Bloomberg's swap platforms involve non-US banks and other foreign institutions. An entity seeking to register as a SEF desires to have consistent standards applicable to both SEFs and market participants across different jurisdictions. Without such coordination a SEF may be put in the untenable position of enforcing rules against certain participants

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

that are inconsistent, or worse, conflicting with foreign rules. Moreover, without harmonized and consistent standards a SEF could be required to have one set of rules for US participants and another set of rules for non-US participants, with a further set of transaction-level rules based on the counterparties or underlying instruments. The resulting legal uncertainty associated with an uneven playing field and regulatory arbitrage can be a significant disincentive to becoming a SEF, to maximizing a SEF's availability to market participants, or to the scope of the products offered for trading on the SEF.

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

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

Having said that, predicting the number of SEFs globally is complicated by the fact that outside the US there are no specific regimes to regulate swaps as SEFs are envisioned by Dodd-Frank. It can be said that in terms of US-registered SEFs, the number of SEFs will be inversely proportional to the number and strength of barriers to entry. In this regard, the problem we foresee with unnecessary and unwise limitations on the flexibility of SEFs to determine their own trading protocols will be paramount. To

the extent that SEFs are homogenous, required to fit a specific "one size fits all" regime on trading protocols, they will increasingly resemble cookie cutter utilities, providing less innovation and responsiveness to market participants' evolving needs for those SEFs in the market and less incentive for new SEFs to enter the market to compete with incumbent SEFs. But the more flexible SEFs can be with their trading protocols the more incentive there will be for all SEFs to distinguish themselves with innovation, vigorous competition and increasingly more cost effective functionality for the market—all of which enhances the incentive for SEFs to come into the market in greater numbers.

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

The key public policy element we would suggest to Congress and the federal regulators to better support successful development of SEFs relates to flexibility of trading protocols. There is little disagreement that clearing and transparency are good for the market and will reduce systemic risk created by large concentrations of derivative positions. However, overly prescriptive methods of execution threaten market liquidity and create risks of unintended adverse consequences such as incentivizing trading that avoids SEFs (dark pools) and flight to less regulated foreign markets. Enabling SEFs to rely on aspects of the DCO compliance regime that would otherwise replicate compliance obligations imposed on SEFs would reduce SEF costs and incentivize SEFs to focus productively on their trading protocols which will maximize innovation, competition and market responsiveness.

Conclusion:

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

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

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

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

JUNE 29, 2011

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

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

As an initial matter, it is important to note that Eris Exchange is not a SEF. Eris Exchange filed an application with the U.S. Commodity Futures Trading Commission ("Commission" or "CFTC") on April 18, 2011 to be designated as a contract market (a "Designated Contract Market" or "DCM"). A DCM is the traditional exchange - a board of

trade - on which futures contracts have been traded for over a hundred years.[1] Eris Exchange anticipates that it will be a DCM on or before October 18, 2011. As a DCM, Eris Exchange will be permitted to list both traditional financial futures, such as its current Contract, as well as, swaps subject to the Dodd-Frank Act. As such, Eris Exchange will satisfy the Dodd-Frank execution mandate and will compete with SEFs in the cleared interest rate swap space. Eris Exchange has made the business decision to register as a DCM for several reasons, including the ability to offer futures contracts, high capital efficiencies of trading futures through margin offsets, and open access. Therefore, Eris Exchange is uniquely positioned to provide testimony on the experience of a start-up exchange formed in response to the unprecedented regulatory evolution currently underway.[2]

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

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

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

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

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

I. BACKGROUND ON ERIS EXCHANGE

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

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

Eris Exchange's initial product offering is due, in part, to the regulatory certainty that has existed for decades with financial futures contracts and the benefits a futures product offers participants, such as execution and clearing certainty and margin offsets with traditional financial futures. The Eris Interest Rate Swap Futures Contract embeds all of the economics of a standard OTC interest rate swap into a single futures price. The Contract is independently marked-to-

market and settled every day based on data from the overall interest rate market. The Contract does not have periodic cash flows like standard OTC swaps, but replicates the economics of accrued and expected cash flows in the futures price, resulting in cash transfers through the daily variation margin process. In other words, Eris Exchange has "futurized" an interest rate swap.

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

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

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

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

III. THE MARKET IS IN A "STATE OF READINESS" FOR DODD-FRANK IMPLEMENTATION: CLEARING, TRADING, REPORTING

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

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

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

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

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

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

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

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

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

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

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

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

IV. ERIS EXCHANGE DEMONSTRATES THAT THE DODD-FRANK GOALS ARE ACHIEVABLE IN A PRINCIPLES-BASED REGULATORY ENVIRONMENT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

VI. CONCLUSION

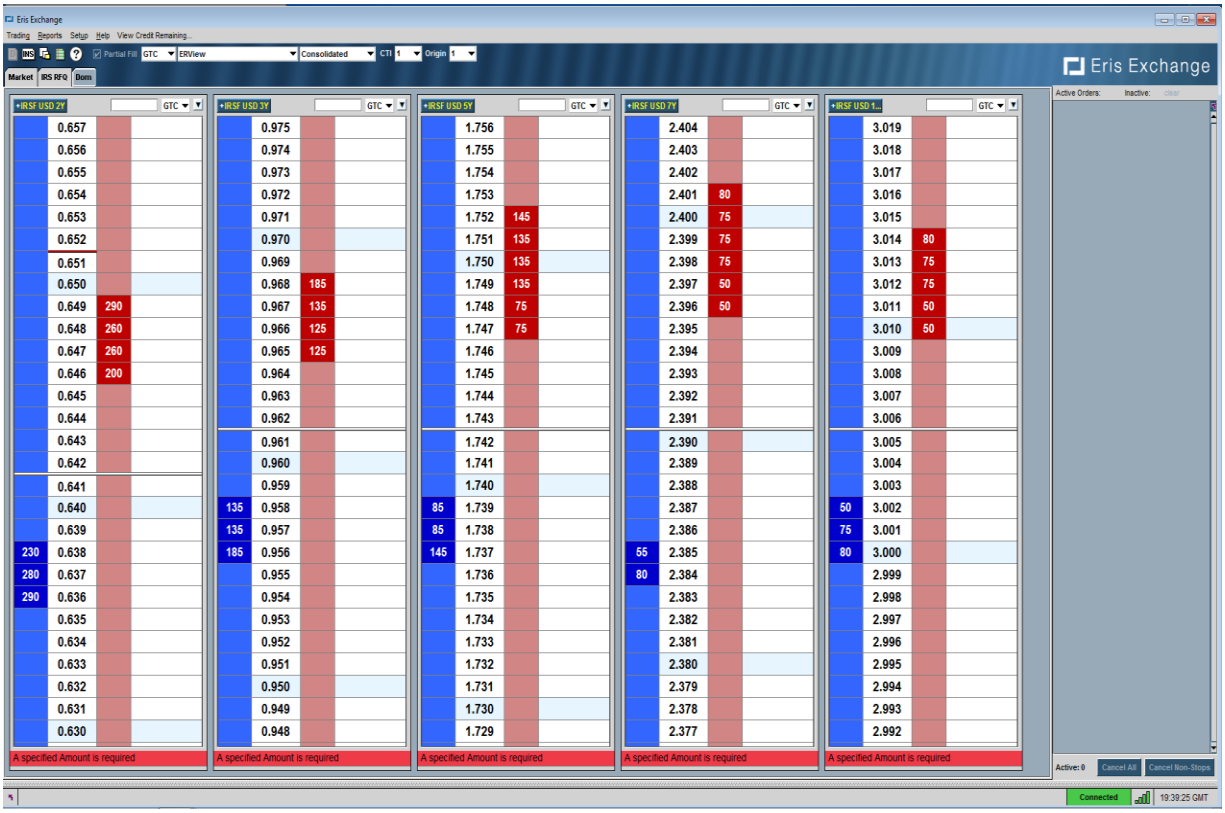
Eris Exchange appreciates the opportunity to comment on this matter. Eris Exchange is fully operational today for trading and clearing of interest rate swap futures, and our product and trading protocols embody the guiding principles of the Dodd-Frank Act. In implementing the Dodd-Frank Act, we believe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

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

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

APPENDIX:

ERIS EXCHANGE, LLC CENTRAL LIMIT ORDER BOOK, JUNE 2011



Testimony of James Cawley

Javelin Capital Markets

Swaps & Derivatives Market Association

for

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

United States Senate

June 29th, 2011

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

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

Thank you for inviting me to testify today.

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

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

Product Eligibility and Open Access

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

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

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

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

Open Access to Clearing Houses

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

Clearing houses should refrain from using their SEF sign-up documentation as a vehicle to restrict trade. As a precondition to access, clearing houses should not require that SEFs sign "non-compete" clauses, such that a clearing house's other businesses – be it execution based or not – are inappropriately protected from outside competition.

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

Real Time Trade Acceptance

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

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

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

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

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

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

Execution Documentation Efforts

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

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

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

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

Conclusion

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

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

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

TESTIMONY

MR. CHRIS BURY, CO-HEAD OF RATES SALES AND TRADING

JEFFERIES & COMPANY, INC.

UNITED STATES SENATE

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

JUNE 29, 2011

"EMERGENCE OF SWAP EXECUTION FACILITIES: A PROGRESS REPORT"

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

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

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

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

- **First**, we are ready to go. From our perspective, the architecture, infrastructure and technology necessary to bring the over-the-counter derivatives markets into an era of transparency, dispersed counterparty risk and open access are in place. Just as we are a leading provider of liquidity and execution in stock and bonds, we believe we can become a leading provider to buyers and sellers of derivatives. The market awaits the adoption of final rules – it is a fallacy to suggest that rules should be delayed to allow more time for this market structure to develop.
- **Second**, we believe that those sections of Title VII of Dodd-Frank pertaining to SEF trading of derivatives are necessary to remedy the artificial barriers to entry in the OTC derivatives market. It is with the intention of enhancing market participation and fostering competition that we support prompt implementation of these requirements.
- **Third,** implementation timelines should be the top priority at this juncture. The proposed rules are generally clear and understandable. The market needs the certainty of <u>when</u> the rules will become applicable far more than it needs any more suggestions about how bilateral agreements offer an alternative to central clearing.

- **Fourth**, it is vitally important to guard against the development of market structures that enable opaque bilateral contract relationships to continue to exist. Current standardized-execution-agreement proposals for centrally cleared swaps do nothing but preserve the closed and anti-competitive elements of these markets as they existed prior to the financial crisis.
- **Fifth,** the adoption of the rules and a clear timeline for implementation of Title VII will bring to the markets the same clear benefits gained from similar developments in equities and futures markets: increased access, expanded competition, improved price transparency, and decentralized risk. SEF trading will lead to lower transaction costs, greater liquidity, strengthened market structures and reduced implicit risks to market participants and the American taxpayer.

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

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

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

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

We believe that the concern over these workflow issues and "what-if" scenarios will rapidly fade once the scale and scope of the technological investment in SEFs and a centrally cleared derivatives marketplace is better understood. Significant technological, financial and intellectual resources have been committed by a wide variety of market participants to get SEFs up and running as quickly as possible. Those investments have paid off, as the Financial Times noted last month in its special report on derivatives:

> "[T]he main participants, banks, interdealer brokers and 'big end users' are ready to go when it comes to electronic trading and clearing." (*Financial Times Special Report, May 31, 2011, as quoted in SDMA Letter to CFTC and SEC dated June 1, 2011.*)

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

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

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

market frameworks that provide for immediate certainty of clearing in order to advance the open access provisions and central clearing mandate of Dodd-Frank.

CONCLUSION

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

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

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

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

It is also critical that the mechanisms to move trades quickly and easily from execution to clearing are well defined. If market participants worry that the trade they have just executed on a SEF might later in the day be canceled due to a clearinghouse rejection,

confidence in the entire market model will erode quickly, and severely limiting the transparency and systemic risk reduction Dodd-Frank was intended to improve.

New Market Structure

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

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

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

The exchange model was created over two hundred years ago long before electronic trading and high-speed market data. Today we're creating a new 21st-century market, but why would a paradigm from the 1800s make sense as a starting point? With little

legacy legislation, rules can be written based on what we know now, not based on the structures developed in 1934 via the Securities and Exchange Act.

Trading Style and Membership Requirements

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

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

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

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

Second, we should encourage SEFs to set membership requirements to encourage a variety of liquidity pools. The US equity market presents a good example. Thirteen registered exchanges and another 55 alternative execution venues exist to trade US

equities for a total of 68. Why? Because different market participants trade in different ways and have different needs. Some like to trade in large size, some small; some are very concerned about price while others are more concerned about getting a trade done quickly. Because of this, the equity market responded with new venues to meet those needs.

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

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

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

Clearing

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

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

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

Size of the Market and Open Issues

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

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

Timing

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

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

Winners and losers, however, will not be chosen until after regulatory mandates are in place. Too many market participants still exist and see little economic incentive to shift, in addition to those new market participants waiting in the wings. But even still, working together, regulators and the industry have made significant progress during the past

year, clarifying the view of what the post-Dodd Frank world of swaps trading will look like.

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

Thank you.

Oral Statement of William Thum
Principal and Senior Derivatives Counsel
Vanguard

Emergence of Swap Execution Facilities: A Progress Report
Before the U.S. Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment

June 28, 2011
Washington, D.C.

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

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

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

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

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

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

In view of the time needed to digest the final rules and develop industry infrastructure; to implement complex operational connections required for reporting, clearing and exchange

trading; to educate clients on the changes and obtain their consent to trade in the new paradigm; and to negotiate new trading agreements across all trading relationships, Vanguard supports the following implementation schedule:

- 6 months from final rules: Swap Data Repositories, Derivatives Clearing Organizations, SEFs and middleware providers must complete the build-out of their respective infrastructures.

- 6 to 12 months from final rules: All participants should voluntarily engage in reporting, clearing and trading platforms.

- 12 months from final rules: All participants should be mandated to report all swaps involving all parties. Dealers and major swap participants should be mandated to clear the first list of "standardized swaps".

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

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

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

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

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

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

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

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

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

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