Wholesale Markets Brokers' Association, Americas

Remarks for CFTC Panel on Futurization
January 31, 2013

Chairman Gensler, Commissioners, and CFTC staff,

Thank you for inviting the WMBA to participate in today's Roundtable.

I would like to briefly discuss the history that led to the Dodd-Frank Act and how Congress addressed the swaps-futures dichotomy. I'd like to then quickly discuss two specific differences – block trades and margin– before concluding with thoughts about trade execution venues for swaps and futures.

The Dodd-Frank Act

First, in writing Dodd-Frank, Congress recognized the futures model served that market well, particularly during the financial crisis. Title VII does not change what is in place for commoditized futures instruments.

However, in setting a framework for swaps, Congress adopted something different than the futures model. OTC swaps, with their more episodic liquidity, required a different market structure.

Accordingly, Congress selected and promoted user choice – with competitive execution and clearing, product fungibility and trade execution using "any means of interstate commerce." Congress enacted laws to ensure that OTC swaps are not owned by one vendor and can be executed on any number of competing systems and platforms, including central limit order books, RFQs, price auctions, and multilateral voice systems.

Congressional intent for a distinct swaps regulatory regime is thwarted when the name of a product is changed from swap to future for the sole purpose of moving it from one regulatory framework to another. We should analyze the public policy risks, benefits, and burdens of such regulatory arbitrage, and not the commercial interests of any particular company or industry.

Block Trades

DCMs are authorized to set their own futures block trade sizes and change them at their own discretion. SEFs must follow CFTC-established block trade sizes. The swaps block trade distinction, by law, relates to whether a trade is disseminated as soon "as technologically practicable" or on a delayed basis. This distinction has significant impact on liquidity formation.

Simply changing a swap to an economically equivalent future can impact how the trade is negotiated, executed, and reported.

As proposed, block size will also determine what mode of trade execution can be used by SEFs, such as electronic order book, RFQ, electronic auction or hybrid voice and screen brokerage and other "means of interstate commerce" that are widely used in global swaps markets.

The CFTC is imposing a futures model – in this case, DCMs – on the Dodd-Frank swaps regime that, by law, is not the futures model.

I raise this today because the CFTC is deliberating on final SEF rules and needs to remove the link block trade size and method of trade execution. Swaps block trades should only impact trade dissemination timing, and not trade execution. Not only is the block trade issue important for futurization, but for swaps liquidity formation as well.

Margin

There are important differences in the CFTC's part 39 rules related to liquidation time frames for swaps and futures. A recent Risk article projects that swaps subject to a five-day cure period will generate approximately 2.23 times the margin held against futures subject to a one-day period.

These rules should be re-written so that margin is calculated based on actual trading liquidity and other market data and not on whether an instrument is labeled a swap or future.

Labeling a swap product as a future should not automatically result in more favorable margin treatment when the economic characteristics are otherwise identical. It is troubling that futures exchanges are currently touting the lower margin cost for swap futures over swaps as part of their printed sales pitch.

If swaps are over margined, then the additional cost is borne by the U.S. economy where corporate end users have to pay artificially high clearing costs to hedge business risk.

If futures products are under-margined, then clearing houses will absorb more risk, particularly during a liquidity crunch or a downgrade of its clearing members. Remember, these clearing houses are designated as systemically important financial market utilities under Title VIII of the Dodd-Frank Act.

If inadequate margin causes a liquidity crisis, concentration of risk at clearing houses may require these "SIFMUs" to access the Federal Reserve discount window, putting the US taxpayer once again on the hook.

Trade Execution Rules

Finally, I urge the CFTC to ensure competition between SEFs and DCMs when finalizing the SEF rules. SEFs must meet impartial access requirements, intended to permit equal and open participation and vibrant competition for the benefit of users. In contrast, the futures rules

protect dominant market forces by permitting them to further entrench their dominant positions and exclude competitors.

If participants prefer futures to swaps, so be it, but it is disingenuous to suggest that swaps and futures are competing on a level playing field, with a neutral referee and neutral rules, with the outcome driven by product characteristics and user preferences.

Even if futurization is inevitable because of a natural migration to order books as swaps become more liquid, it still begs the question why greater liquidity must move to order books operated by single-silo non-fungible exchanges?

WMBA members and other companies operate sophisticated electronic order books, ranging from giants like Bloomberg to start up boutiques. With increased liquidity, why can't these products trade on competitive SEFs and exchanges offering a wide array of trading methodologies?

The Commission should ensure a level playing field for market participants – whether for swaps or futures. If two products act and look alike, they should be subject to the similar regulations, set regardless of the label.

Thank you for your time. I look forward to a great discussion.