WRITTEN TESTIMONY
OF
COMPANIES SUPPORTING COMPETITIVE DERIVATIVES MARKETS
FOR THE
CAPITAL MARKETS AND GSEs SUBCOMITTEE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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Chairman Garrett, Ranking Member Waters, thank you for the opportunity to submit written testimony on the economic and market implications of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The companies[1] supporting competitive derivatives markets are composed of individual market participants who support the intention of Congress to bring transparency to and reduce systemic risk in the futures, options, and swaps markets.

Responding to public outrage fueled by the financial crisis in 2008, world leaders convened for a G-20 meeting in Pittsburgh in September 2009, and agreed that the $700 Trillion global over-the-counter swap markets must be regulated, not eliminated. In July 2010, Congress passed and the President signed Dodd-Frank into law to do just that. While some lobbied for the end of the swaps market in favor of futures products, Congress concluded that it was important to preserve the $300 trillion U.S. swaps market which had grown organically for almost 30 years. Congress carefully drafted each provision of Title VII of Dodd-Frank and directed the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) to implement it with two specific goals in mind: reduce systemic risk in the U.S. swaps market through measured regulation and preserve the role of swaps in the U.S. economy. We vigorously support and respect those goals.

Congress intended to reduce systemic risk in the swaps markets by increasing transparency. To that end, Title VII explicitly requires swap transactions to be reported to data repositories, it requires certain swaps to be traded on regulated platforms to promote the goal of pre-trade price transparency, it requires post-trade reporting of swap transactions to the public in

[1] The individual companies who support competitive derivatives markets include the following market participants: GFI Group Inc., ICAP, Tradition, Parity Energy, Inc., Tradeweb Markets LLC, Thomson Reuters Corporation, and Bloomberg, L.P.

real-time, and it contemplates that swaps should be able to be traded on regulated platforms and cleared at any clearinghouse willing to accept them. While the specific implementation of these policies was left to the CFTC and SEC, Congress went to great lengths to set forth a regulatory structure designed to reduce risk, increase transparency, and preserve the character of the U.S. swaps markets. Congress understood that regulating the U.S. swaps markets would be among the most significant market structure undertakings since 1934.

So where are we now? After nearly 2 ½ years of rulemaking, the CFTC's cumulative approach to swaps regulation has imposed such high costs on the industry that the U.S. swaps market is on the verge of becoming too costly and too regulated (particularly as compared with futures) to be a viable means for end user to hedge and manage their financing risk.[2] The overwhelming differences between swaps and futures rules on determining block trade sizes, real-time reporting, registration, cross-border trades, business conduct, and potentially, most important, the cost of margin and capital is threatening to strangle the U.S. swaps market in favor of the futures market through the technicality of a "swap future".[3]

It appears that by simply changing the name of the product from a swap to a swap future, market participants can avoid swap regulation entirely. In its attempt to regulate the swaps market in a different manner than the futures market with respect to economically equivalent financial instruments, the CFTC created regulatory arbitrage between the only two products under its jurisdiction: swaps and futures. By creating an unequal playing field between economically equivalent swaps and futures, the CFTC's swap regime may find itself directly at odds with Congress' intent to preserve the U.S. swaps market.[4]

[2] A number of buy-side market participants are concerned about reaching the $8 billion de minimus swap dealer safe harbor notional amount and being classified as a swap dealer simply because they are required to include the notional value of cleared swaps in the de minimus calculation. Our view is that cleared swaps should not count towards the de minimus amount.

[3] http://cftc.gov/PressRoom/SpeechesTestimony/opaomalia-18; ("Given the inconsistency in the Commission's interpretation of its own rules, the lack of regulatory certainty and the increased cost of compliance with the Commission swaps regulations, including the complicated and controversial swap dealer definition rules, swap customers have turned to futures markets for regulatory certainty. ICE will become the first exchange to take such a step ahead of new financial regulations, but I suspect they will not be the last"). http://www.cmegroup.com/trading/interest-rates/introducing-deliverable-interest-rate-swap-futures-webinar.html; http://ir.theice.com/releasedetail.cfm?ReleaseID=713717.

[4] A 10 year plain vanilla interest rate swap and a 10 year swap future represent the same risk instrument, yet the swap future is subject to an entirely different, less transparent, more opaque and less expensive regulatory framework than the 10 year interest rate swap. See also http://www.risk.net/risk-magazine/news/2208965/ice-move-from-swaps-to-futures-unlikely-to-be-last-says-o-malia; ("While I certainly don't believe it was the intent of Congress or the commission to draft rules that would drive people out of the swaps market, the regulatory uncertainty was so great that energy markets voted with their pocket-books and moved their trading business from the regulatory nightmare of swaps markets to the … futures markets").

Does it serve the public interest when the federal government, through a regulatory framework, effectively creates a mandate that swaps be converted into swaps futures? Does it bring additional transparency or the reduction of systemic risk to the broader derivatives markets? On close examination, we believe the answer is “no”.

First, does the conversion of swaps to swap futures enhance competition? The answer is no. Swap futures are not subject to the same trading fungibility and open access clearing requirements that Congress requires of swaps; thus, the vertical monopoly of the futures industry is further entrenched and competition from swap execution facilities (SEFs) and new derivatives clearing organizations is greatly reduced.[5] Importantly, by removing choice of product and venue farmers, corporates, pension funds, insurance companies, and consumers will be subject to increasingly higher costs for execution and clearing. Competition has been further impacted by the delay in the SEF rules as compared with the rules for exchanges.[6] In the absence of a SEF framework and infrastructure, the marketplace is moving away from that uncertainty toward the existing exchange and swap future paradigm – effectively giving the vertical silos an even more entrenched monopoly.

Second, does the conversion lead to greater transparency? The answer is no. Swap transactions are required to be reported to a data repository that regulators can access to conduct market surveillance and systemic risk oversight. Swap futures contracts are not. Swap transactions are statutorily subject to real-time post trade reporting on a publicly accessible data repository website. Swap futures contracts are not. These differences ensure that, unlike the swaps markets, only those entities or individuals with the resources to afford real-time data for swap futures contracts will have access to it. In addition, commercially operated exchanges control the size of block trades for futures contracts, unlike swaps where the block size is set by the CFTC and SEC. The inevitable result will be differing minimum block sizes between swap

[5] http://www.risk.net/risk-magazine/news/2224931/risk-usa-futurisation-trend-could-hurt-sefs-says-cftcs-chilton ("Attempts to convert over-the-counter derivatives into listed products may hurt swap execution facilities")

[6] http://cftc.gov/PressRoom/SpeechesTestimony/opaomalia-20 ("Unfortunately, the Commission’s rulemakings have already disincentivized trading on swaps venues by implementing burdensome swap dealer registration rules and disadvantageous margin requirements for swaps. As a result, energy traders fled from the swaps market to the standardized futures markets in October, a transition dubbed “futurization,” just ahead of the effective date for swaps regulations.").

futures and swaps, with futures exchanges looking to gain commercial advantage. Certain market participants will look to arbitrage the differing block sizes to conduct transactions off-exchange or off-SEF depending on where they can access greater trading opacity outside the broader liquidity pool.[7] As a result, whether a derivative instrument is called a swap or a swap future and not its underlying risk profile will determine its price transparency.[8] In short, the CFTC's rules, with respect to economically equivalent instruments, favor the futures markets over the swaps markets, and the CFTC (or Congress) must address these differences. As currently constructed, these rules undermine the benefits to the public that Congress intended for Title VII.[9]

Third, does this conversion protect those Congress intended to protect? All of the transparent business conduct protections that the consumer advocate groups fought so hard to include in Title VII to protect pension funds, schools, and municipalities (Special Entities) from the risks of swap transactions can be legally evaded using an interest rate swap future.[10] There is no obligation for a Special Entity to engage a fiduciary-like advisor to act on its behalf to detail the risks or costs associated with the use of an interest rate swap future. There is no obligation to disclose conflicts of interest when marketing an interest rate swap future to a Special Entity. Again, by simply changing the name of the product, the taxpayer, retiree, and ordinary citizen are left completely unprotected from some of the risks that Title VII was designed to prevent. As the Consumer Federation of America and the Americans for Financial Reform rightly noted in a comment letter to the CFTC, "with the adoption of the business conduct provisions of the act, Congress clearly intended not just to provide greater transparency, though that is important, but also to transform the nature of the relationships, particularly with regard to special entities."[11]

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[7] If futures exchanges can set lower block sizes than SEFs, it essentially gives the exchanges the ability to offer an off-exchange request-for-quote (“RFQ”) to one (1) on swap futures, whereas as an RFQ to one (1) on a SEF for an economically equivalent swap with similar volume would not be permitted. RFQ functionality allows a market participant to determine how many counterparties it would like to receive quotes from prior to determining whether to execute a market transaction. In addition to block trading arbitrage, this also results in regulatory arbitrage among methods of execution.
[8] http://cftc.gov/PressRoom/SpeechesTestimony/opagensler-124 (According to Chairman Gensler, "[t]ransparency lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition. ").
[9] Moreover, Title VII also requires swap dealers and "major swap participants" to register with the CFTC, which provides direct transparent supervision and accountability of trading and risk management practices. In sharp contrast, there is no such requirement for most traders of futures products.
[10] *Id*. ("The product brochure for CME Group's new swap futures contract - which starts life as a future but delivers into an OTC swap - advertises the product as a way for users to "sidestep many of the challenges that may be associated with OTC derivatives in the current market environment").
[11] http://www.consumerfed.org/pdfs/cftc-business-conduct-standards-comment-letter.pdf

We would suggest that the differences between swaps and swap futures have made certain that will not happen.

Fourth, has the conversion reduced systemic risk in the broader derivatives markets? We would argue that it has not. Swap futures are imperfect hedges and they will cause market participants to self-insure the basis risk that the swap future does not hedge. This outcome promotes a buildup of the same type of opaque unregulated balance sheet risk that plagued numerous entities during the 2008 crisis, and it will be dispersed throughout the system.[12] Additionally, because futures contracts expire and market participants are forced to "roll" the expiring contract on the expiration date into a new contract to maintain the hedge, they are now exposed to market risk and the possibility that high frequency traders will time the roll and cause the price of the contract to increase. This will lead to more volatile credit markets, which can exacerbate systemic risk and negative feedback loops in times of market uncertainty and crisis.

We would also highlight that the unequal margin requirements that the CFTC set forth for economically equivalent swaps and futures will lead to an increase in concentrated risk. A financial swap requires a 5-day margin and a financial swap future requires a 1-day margin.[13] Why? If the risk to the U.S. financial system is the same, then why are economically equivalent products treated differently. By requiring clearinghouses to hold lower margin for a swap future with the exact same risk as its economically equivalent swap, the CFTC is not reducing risk in the system; its policies are actually forcing the clearinghouse to absorb more risk. In a liquidity crunch or a downgrade of its clearing members, a clearinghouse will require more, not less collateral, to protect itself from cascading defaults, and this problem is exacerbated if the required margin held at the clearinghouse was inadequate to begin with. Margining the swap future at one day could aggravate risk to clearinghouses, market participants, and the U.S. financial system during the exact time when the system can least afford it: episodes of market uncertainty and crisis.

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[12] http://www.ft.com/intl/cms/s/0/cadeef74-2377-11e2-a46b-00144feabdc0.html, "U.S. Swaps Shake-up Set to Boost Exchanges" ("This migration raises the prospect that once interest rates or energy prices change rapidly, many investors may be caught out by relying on a future rather than a customized swap that better matches their portfolio's risk.").

[13] 76 FR 69438 Rule 39.13(g)(ii), November 8, 2011 (*Derivatives Clearing Organization General Provisions and Core Principles*).

Fifth, does the conversion benefit Main Street consumers? The answer again is no. The Main Street consumer's insurance company, or the firefighter's, policeman's and teacher's pension fund, or the farmer, or the corporation that is the single employer in a town that previously used swaps are all worse off. They have lost access to pre-trade price transparency, they have a ten (10) minute delay on post-trade price transparency unless they pay hundreds of thousands of dollars to obtain access to it in real-time, they have imperfect hedges that expose them to market volatility, price volatility, and high frequency trading strategies, they are forced to pay increasingly higher costs to trade and clear their derivative contracts because there is limited price competition, and they could be forced to bailout a clearinghouse in a crisis because the margin levels are insufficient.[14]

Sixth, how does the conversion impact the jurisdiction of this Committee? Subtitle A of Title VII clearly sets out that the CFTC regulates swaps, futures, and options[15] and Subtitle B of Title VII states that the SEC will regulate security-based swaps, which include equity swaps, single name credit default swaps, and narrow-based indexes composed of less than 10 entities.[16] Swap futures are futures, and therefore, they are regulated by the CFTC, not the SEC. If almost all of the security-based swaps that this Committee worked so diligently to make certain were under the purview of the SEC are converted to swap futures, which is highly likely given the economics of the contracts, it is possible that this Committee could lose a large amount of its jurisdiction over the swaps market going forward. We find that outcome problematic and squarely against the Congressional intent expressed in Subtitle B of Title VII.

We cannot overstate the impact this conversion is having on the U.S. swaps market, and this is not a hypothetical concern. To illustrate this point, one has to look no further than the energy swap market in the U.S., where almost all of the transaction volume has left the OTC swap market and is now being executed through various energy swap futures contracts.[17] The

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[14] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010), see Title VIII.
[15] *Id*. See Title VII-Subtitle A.
[16] *Id*. See Title VII-Subtitle B, see also CFTC Final Products Rule: 77 FR 30596, May 23, 2012 (*Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant''*).
[17] https://www.theice.com/publicdocs/ICE_Swaps_to_Futures_FAQ.pdf ("All of ICE's cleared OTC energy swaps and options will be transitioned to exchange-listed futures and options… The transition of existing open interest in cleared OTC swaps and options (cash-settled) positions will take place over the weekend of October 13-14, 2012.")

market's move from energy swaps to energy swap futures was a direct response to the CFTC's swap regulations.[18] We are elevating our concerns to your Committee because this market transformation is taking place without public comment or a regulatory impact study that analyzes how the conversion will affect systemic risk, transparency, competitiveness, market participant choice, consumer protections and the other important public policy issues Congress sought to address in Title VII. As a result, we fear that Dodd-Frank's goals of reducing systemic risk through transparency and preserving the U.S. swaps market are becoming increasingly more difficult to achieve.

We urge Congress to think about the following questions as it continues to carry out its important Constitutional oversight authority: (1) is the swap future good for the stability of the U.S. financial system?; (2) should Congress require the CFTC to revisit each rule that created the unequal playing field between swaps and swap futures?; and (3) should Congress revisit Title VII to level the playing field by (A) imposing the same statutory requirements on futures contracts as it has on swaps?, and/or (B) mandating that swap futures be regulated as swaps?. At the very least, we would ask Congress to mandate that (1) regulators require any new product proposals by exchanges that convert swaps, as regulated by Title VII of Dodd Frank, into swap futures to be subject to the transparency of the public comment process before further products impacting this conversation are permitted to proceed, and (2) the Government Accountability Office (GAO) be directed to immediately conduct an impact study that analyzes how the conversion from swaps to swap futures will affect systemic risk, transparency, competitiveness, market participant choice, consumer protections, and the other important public policy issues Congress sought to address in Title VII.

We thank the Committee for the opportunity to present our concerns.

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[18] Id. (http://www.risk.net/risk-magazine/news/2208965/ice-move-from-swaps-to-futures-unlikely-to-be-last-says-o-malia. ("Other participants agree the decision by Ice to move the date of its transition reflects regulatory uncertainty for swaps - and even suggest the decision demonstrates energy traders think the regulatory framework is unworkable. "Ice and its customers have rejected swap regulation. They believe the CFTC's swap regulation is so unworkable that they are transforming their market and their products from swaps to futures. That is a huge vote of no confidence in the CFTC's regulation," says Mark Young, a partner specializing in derivatives regulation at law firm Skadden, Arps, Slate, Meagher & Flom in Washington, DC. "The CFTC piled a wealth of unnecessary elements into its swap regulation. Its rules are too confusing, too costly, and Ice is essentially telling the CFTC that it has gone too far and people would rather trade futures instead of swaps. That is a very big deal." he adds.").