Testimony of James Cawley

Javelin Capital Markets

Committee on Financial Services

U.S. House of Representatives

February 15, 2011

Introduction

Chairman Bachus, Ranking Member Frank, and Members of the Committee, my name is James Cawley and I am CEO of Javelin Capital Markets, an electronic execution venue of OTC derivatives that expects to register as a SEF (or "Swaps Execution Facility,") under Dodd Frank. Thank you for inviting me to testify at today's hearing.

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

In called to testify today, I am reminded of the main reason for which we are here—to fix the derivatives market such that we never again have to call upon the US taxpayer to bail out Wall Street. The bilateral counterparty risk baked into every credit derivative and interest rate swap contract still constitutes an unacceptable systemic risk to the national financial payments system specifically; and to the broader economy as a whole.

Simply put, such bilateralism acted as an accelerant to the crisis, much like gasoline does to a forest fire.

To help ensure, in the future, that the government or more specifically, the US taxpayer, doesn't have to bail out the next trading firm that fails—we must ensure that the central clearing and transparent, competitive execution of OTC derivatives, as specified under Dodd Frank, is a success. We must transition away from 'too interconnected to fail,' where one firm fails and pulls three others down with it.

Where We Are Now

We are now 2 ½ years since the financial crisis of 2008 and despite several industry-led initiatives, the market has since failed to migrate by itself to central clearing. What have emerged, however, are examples of 'good' and 'bad' clearing initiatives from which lessons can be drawn.

Structural barriers to universal adoption of central clearing have emerged that include: caps on open interest, clearing costs being shifted permanently to end users to the benefit of an incumbent few, and severely restricted access for execution venues and new dealers as they seek to compete and enhance liquidity.

These observations should serve as useful guidance for the SEC and CFTC as they promulgate rule sets based upon Dodd Frank.

Central Clearing

With regard to clearing house membership requirements, they should, as Dodd Frank requires, be objective, publicly disclosed & permit fair and open access.

This is important because clearing members act as the 'gatekeepers' to clearing. Without open access to clearing, you will not have universal clearing adoption, increased transparency, liquidity and lessened systemic risk.

Clearing houses should not place unreasonable requirements for capital, require them to be swap dealers or determine eligibility based upon the preexisting size of a swap portfolio.

Clearing houses should learn from their own experience in the listed derivatives space (of futures and options) where they currently operate. In those markets, central clearing has operated successfully since the days of post Civil War Reconstruction nearly 150 years ago, long before spreadsheets and risk models. In the listed derivatives marketplace, counterparty risk is spread over a hundred disparate and non correlated clearing firms. It works well and no customer has ever lost money due to a clearing member failure.

This is not the case presently with the current OTC Derivatives clearing initiatives on offer. Membership in these entities stands to be too restricted, with a mere handful of highly correlated players not only shouldering the risk, but also controlling the access.

We should be mindful that calls for initial membership capital to be $5 billion or $1 billion, while they sound great, are cosmetic and that only a 'pay to play' system where capital contribution is directly proportionate to the risk introduced is a better way to go.

To that end, the SDMA supports the CFTC's call for clearing broker capital requirements to be proportionate and scale relative to the risk they introduce. We support the CFTC's call that a clearing firm's minimum capital be closer to $50 Million, than to $5 billion or $1 billion as certain CCP's have originally suggested.

It is worth remembering that Lehman and Bear Stearns would have met the $1 Billion threshold until the days of their failure.

We support initiatives to broaden clearing house membership well beyond that of only a few highly correlated players such that if one, or two, or even three clearing members fail—(as evidenced in the Fall 2008), the broader group can comfortably shoulder the burden.

Furthermore, some operational requirements for membership that have no bearing on capital adequacy or clearing member capability should be seen for what they are—transparent attempts to limit competition.

Specifically, clearing members should not be required to operate swap dealer desks just so they can meet their obligation in the default management process. These requirements can easily be met contractually through agreements with third party firms or dealers.

Clearing house governance should be balanced and transparent. Such governance bodies should represent the interests of the market as a whole and not just the interests of the few. To ensure fair governance, clearing house voting should be, as the CFTC and the SEC have suggested, strictly monitored where one entity or group does not exercise undue influence.

With regard to conflicts of interest within a clearing member, Dodd Frank is clear; dealer desks should not be allowed to influence their clearing member colleagues and strict Chinese walls should exist. Dealer desks should not be able to force their clearing member colleagues to offer 'free clearing' if you execute with the dealer desk.

OTC swaps clearing has been quite prevalent in the commodity swaps space since May 2002, following the collapse of Enron in 2001. Moreover, this has occurred without arbitrary rules designed solely to exclude a large number of clearing members. There have not been artificially set high capital requirements for clearing members or rules for default management that only dealers can meet. If this Committee wants to review a model for OTC clearing success, it needs to look no further than the Chicago Mercantile Exchange's Clearport initiative; ICE's OTC clearing initiative in Europe, or the Singapore Exchange's AsiaClear Platform in Singapore.

Derivatives Trading

With regard to trading derivatives, clearing houses must accept trades on an execution blind basis. Customers should be allowed to trade with whom they want. They should not be forced to execute trades in such a way where one side of the trade be done with a clearing member who is also a dealer.

Customers should be allowed to execute on whatever swap execution facility and with whomever they want. They should be able to trade with dealers who do <u>not</u> self clear, but make markets and provide liquidity, so vital to the integrity of the system.

Moreover, clearing houses should seek to settle trades real time and not attempt to increase market risk by extending out settlement periods over days. Regulators should be mindful that delay in the settlement process can only serve to foster fear and lack of faith in a marketplace.

For their part, Swap Execution Facilities should also offer open access and transparency in an otherwise opaque marketplace. They should offer *pre* and *post* trade transparency and offer a fair and objective marketplace--where buyers and sellers come to transact their business.

SEFs should seek to confirm and report their trades within seconds; as is the case in other markets. In these days of high technology, such trade reporting and settlement is not overly burdensome and helps to increase the integrity of a market.

Swap execution facilities should be allowed to compete for liquidity and market share.
It is well established in other markets, that, with the introduction of greater transparency, more market makers and increased competition a safer playing field emerges to directly enhance liquidity and market integrity that in turn lowers systemic risk.

Conclusion

The CFTC and the SEC should be commended for their excellent hard work so far. Both agencies have been transparent and accessible throughout the entire process. The rule sets promulgated so far have been well thought out, deliberate and executed with great diligence. While consistent with Dodd Frank, they have adapted to the industry comment when appropriate. For example, with regard to the SEF execution method, they provided for a workable compromise in which *central limit order* books and *request for quote* models would both qualify under the transparency provisions of Dodd Frank.

In conclusion, we must move away from 'too interconnected to fail.' We must move away from tax payer bailouts of Wall Street and we must all work together—Congress, the regulators, the incumbent dealers, the new dealers, the buyside and the clearing firms to ensure that central clearing under Dodd Frank, which is properly thought out works-- and works well. I thank the Committee for the opportunity to speak.

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
James Cawley	Javelin Capital Markets, representing Swaps & Derivatives Market Association (SDMA)

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ XX No	☐ Yes ☒ XX No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.