Statement of
Christopher Ferreri, Managing Director of ICAP,
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Thank you, Chairman Kanjorski and Ranking Member Garrett, for allowing me the opportunity to participate in today's hearing. This morning I will be offering testimony to provide additional insight for the Committee into the Interdealer over the counter (OTC) derivatives marketplace, our views regarding OTC regulation, the benefits of electronic trading and clearing, the distinction between exchange trading and clearing, and how ICAP has helped to develop solutions to make these markets become more efficient and transparent.

There are many components to the financial markets and I work for a company that occupies a very unique space that few people outside of our business have ever heard of: the Interdealer Broker (or IDBs). Broker/dealers and other large financial institutions use IDBs in the secondary over the counter markets to execute their customers' orders, trade for profit and manage their exposure to risk. There is no centralized exchange in the OTC market, and as a result, financial institutions use the IDBs for price discovery and liquidity.

Although I began my professional career as an Electrical Engineer, I became a US Treasury broker in 1984 and have been with the same company ever since. My degree in Electrical Engineering seemed to have little to offer initially in my work as a broker, however, that education prepared me well to assist in the transition of our business from voice brokering to electronic trading; my daily responsibilities are focused on the continued migration of products onto our electronic platforms.

ICAP is the world's leading Interdealer Broker. As an IDB, our objective is to match willing buyers and sellers, and in that process, provide services from distributing market data to automating post trade services. Our customer base is mostly made up of professional traders from large financial institutions and no single customer contributes to more than 5% of our revenues.

ICAP is a publicly held company traded on the London Stock Exchange under the Symbol (IAP), and has 4,300 employees worldwide. We maintain a strong presence in the three major financial markets, New York, London and Tokyo, with a local presence in 30 other financial centers around the world. ICAP covers a broad range of over the counter products and services in interest rates, credit, commodities, foreign exchange, and equity markets as well as data, market commentary and indices.

While ICAP does broker credit default swaps (CDS), it is a relatively small part of our overall OTC and exchange-related business.

ICAP's post trade services include: Traiana, which automates post-trade processing for over 50 of the world's largest financial trading groups; Reset, a company that helps in reducing mis-matched forward rate agreements; TriOptima, which reduces counterparty credit funding through portfolio reconciliation and portfolio compression; and a joint venture with CLS, designed to reduce risk and costs in pre-settlement processing for the global FX markets. ICAP is committed to the benefits of central clearing and also recently announced that we are part of a consortium to acquire LCH.Clearnet. All of these initiatives have firmly placed ICAP in the realm of global post trade provider. ICAP is the only IDB in the world with such a wide breadth of both electronic and post trade capabilities.

Today, ICAP is the largest Interdealer Broker in US Treasuries with average daily volumes of more than 100 billion dollars, 87% of which is electronic. ICAP has successfully migrated a number of our businesses from telephones to screens and ultimately to electronic trading, and we have served as a bridge to maintain liquidity while improving efficiencies.

As an integral part of the over the counter markets, we feel that ICAP has unique and helpful insight on the importance of the derivatives markets and the central role they play in risk management and economic growth.

We offer this testimony as a participant in the markets, whose primary purpose is in helping our customers find liquidity. We compete for their business on a value-added basis. In my testimony today, I would like to offer some insights into the OTC markets, the Interdealer markets, and in particular, ICAP, as well as our viewpoint on the methods in which the markets can operate more openly.

1. **Our view on the need for OTC regulation**
    a. Interdealer brokers like ICAP are regulated with regard to many of their activities by national functional regulators and Self-Regulatory Organizations (SROs). ICAP's entire business is also overseen by its lead regulator.
    b. Regulators should have increased access to information about trading in the OTC markets and the outstanding positions held by counterparties.
    c. There are already in place many forms of regulation that apply to the OTC cash and derivatives markets. In cases where the markets themselves may not be regulated, regulations apply to banks and other market participants in the different markets.

d. The OTC markets operate on a global basis. Unless there is global coordination of changes in regulation, there is the risk that activity could be transferred from closely regulated markets to less regulated ones.

2. **How clearing will affect the OTC market**
   a. Many OTC traded markets already enjoy the benefits of clearing through independent clearing houses to reduce counterparty credit risk and increase capital efficiency - fixed income markets like US Treasuries, Repo, Mortgage Backed Securities (MBS), commodity derivatives and interest rates swaps are examples.
   b. A key measure of the health of the OTC markets is the availability of multiple, competing trading venues. There should be open access to all trades that are eligible for clearing and are transacted on these venues. There should be automated, secure links between trading venues and clearing facilities.

3. **Should clearing be mandated for all products or only some?**
   a. For products to be cleared, they require the use of standardized documentation and the regular availability of pricing. The vast majority of trades done today in the OTC derivatives markets use standardized documentation and therefore have the potential to be cleared.
   b. There are however products that are not traded frequently, and therefore, although using the appropriate documentation, cannot be cleared. These trades can be collateralized bilaterally to manage the exposure to counterparty credit risk. Systems to further automate the collateralization of these trades are already under development and are expected to be available in the market next year.
   c. Risk margining needs to be appropriate for the underlying asset. If products are cleared, then margins would be lower than for those products that are not.
   d. All trades, whether cleared or not, should be sent to trade warehouses. If they are not cleared, as they are marked to market, this information should also be used to update the trade warehouse. Regulators can then access these data warehouses and monitor counterparty exposures.

4. **The pros and cons of exchange trading**
   a. We must underscore the distinction between exchange trading and clearing. ICAP operates fully electronic marketplaces for US Treasuries, Repo, Agencies as well as the largest global Spot Foreign Exchange market. None of these are single silos of

exchange trading and clearing, but they are traded electronically and do centrally clear. They compete with other systems and offer fungibility of assets.

b. The one-size-fits-all approach of completely standardized non-fungible contracts means that corporations, mortgage providers, bond issuers and others are unable to accurately hedge their risk exposures. It is for this reason that the OTC markets are both larger in scale and broader in scope than exchange markets.
c. OTC markets have developed in parallel with exchange trading; the best example is the very successful operation of the US Treasury cash and futures markets.
d. There have been many instances of unauthorized trading of futures contracts on exchanges leading to significant losses.

5. **The potential benefits of increased electronic trading**
    a. Electronic trading can provide more efficient price discovery, simplify trade capture and trading supervision, materially reduce operational risk, increase audit-ability and create processing capacity in the OTC markets.
    b. Multiple trading venues increase competition, keep costs down and provide security from failure of individual platforms.
    c. For less liquid products, the best electronic platforms use a combination of fully electronic trading and voice trading to increase liquidity.
    d. Settlement cycles can be achieved faster.

6. **How to best achieve a balance between price discovery and liquidity**
    a. Migrating liquidity is difficult; the “turnkey” development of a completely new market infrastructure is unnecessary and will require significant implementation time and incur a high level of risk.
    b. Rather than rushing to develop new infrastructure, better and more extensive use should be made of the tremendous capabilities of the current OTC market infrastructure.
    c. ICAP has multiple examples of the evolution of price discovery from telephone to screens; US Treasuries, Repo, Agencies, MBS, and so on.

7. **Are books and records appropriate for all trades and is warehousing appropriate for all trades?**
    a. Trade reporting and warehousing of trades to provide transparency of market operations and exposures to regulators is appropriate.

b. There are several of these warehouses already in place, to which regulators have access, an example is the TriResolve data warehouse run by TriOptima, which already contains details of some 10.2 million OTC cash and derivative transactions. It is possible that additional tools may be required to analyze this data.

Interdealer Brokers are at the heart of the wholesale financial markets and our primary objective is to bring together willing buyers and sellers to complete transactions. We facilitate the flow of liquidity in both the OTC and exchange-traded transactions between commercial and investment banks and dealers representing companies, governments or other major financial institutions around the world.

Regulation in the OTC markets is necessary and appropriate to ensure fair and transparent markets. In the Interdealer OTC market, the major market participants are regulated. As ICAP operates in all of the regulated areas mentioned, it is worth noting that while the IDBs are not operating a regulated marketplace for non-securities derivatives, in thinking about how much regulation is needed in this area, one should consider that the IDBs have created a marketplace that already has many of the attributes those seeking greater regulation are interested in: deep liquidity pools and transparency of pricing for the actively traded instruments.

The processes of clearing, reporting/monitoring, risk margining, netting and failure handling are all beneficial to the OTC markets. The notion that all OTC instruments can be cleared is unrealistic. What is achievable is identifying appropriate capital requirements for the user of the derivative product; less for standardized derivatives and greater for those which are more customized. Dealers in derivatives would be incentivized to reduce the level of these more customized derivatives by employing trade reconciliation and trade compression techniques. There are a number of methods by which dealers can do this today, including the aforementioned TriOptima.

In addressing how clearing will affect the OTC markets, it is important to first define terms. Central clearing can include use of a central counter-party, as in the Central Counter Part (or CCP) model or not, as in the clearing house model, where the clearing house acts as a central trade repository. Settlement, in either case, can reduce risk for market participants and is a desirable development for the OTC markets. In particular, a CCP can act as a shock absorber and may have many risk management benefits. It also can, and has, lead to increased liquidity, as capital normally set aside for counter-party risk is now freed to be redeployed.

To be clear, settlement through a CCP or clearing house is a separate issue from trading on an exchange, a distinction that needs to be made. It is entirely possible to realize the benefits associated

with the CCP and clearing house models without the OTC markets trading on an exchange. Again, one needs only to look at the interdealer market for U.S. Treasury securities to see this. Traded on multiple regulated transparent electronic trade execution systems, the market leverages the CCP model through the automated clearing and novation capabilities of the Fixed Income Clearing Corporation (FICC), a division of the Depository Trust Clearing Corporation (DTCC). At point of novation, FICC steps in as a central counter-party, assuming counter-party risk and effecting settlement and clearing of submitted trades. This process is fully automated and nearly instantaneous through the use of real-time trade messaging. The benefits as it relates to risk management and market supervision under this structure are clear.

ICAP is well-established in post trade services, and we consider this sector of prime importance to our future. We believe central clearing embodies the transparency and efficiency needed in this area. ICAP's cleared OTC markets include: Interest Rate Swaps; US and EU government bonds and repo products; as well as corporate bonds and energy products. Approximately 60% of our CDS trading in Europe is electronically traded with all live, executable prices posted on these systems. In the US, the sovereign CDS market trades in a hybrid voice/electronic model with all live executable prices posted for all market participants to see. ICAP's businesses submit very large volumes of OTC transactions to the Depository Trust & Clearing Corporation and LCH.Clearnet on behalf of its customers on a daily basis.

The OTC environment offers many examples where execution is on "exchange-like" systems and which are already centrally cleared, with the inherent advantages of transparency and auditability. For example, the US Treasury market trades primarily with the Interdealer Brokers. At ICAP, US Treasury benchmark issues, the current 2-year, 3-year, 5-year, 7-year, 10-year and 30-year bonds trade 100 percent electronically on ICAP's BrokerTec platform. These trades are processed in real-time and within seconds of the completion of a trade are submitted to the Fixed Income Clearing Corporation (FICC) for clearing and settlement. For less liquid, less frequently traded off-the-run Treasurys, the price discovery and trade execution process is more actively negotiated by a voice broker, however, the trade processing and market data are fully automated.

For many people, the "market" typically refers to the stock market. In the stock exchange, tens of thousands of participants submit millions of orders for relatively few securities. The Interdealer Broker OTC market is quite opposite: contract sizes are large and there are a limited number of liquidity providers. Simply put, there are relatively few customers trading a wide variety of assets in large volumes. The customer base is significantly smaller than the number of securities being traded and the IDB market is a wholesale market for institutional professional traders. For the most part, our minimum order amount is one million dollars. In many cases, trades may begin with one or two million, with only two participants, and work up to several hundred million with many participants.

The markets are varied and complex, including foreign exchange, Money Markets, Fed Funds, TBA Mortgages, Commercial Mortgage Backed Securities, US Agencies, US Treasuries, Corporate Bonds, Emerging Market Bonds and CDS, Interest Rate Swaps, Interest Rate Options and many others. Trading protocols, available liquidity, frequency of trades, etc. are all very different and the IDB markets have evolved over time to meet the demands of finding liquidity and reducing costs.

To highlight an example of how markets can evolve effectively and embrace multiple execution venues, consider the following: not that long ago, if you wanted to buy or sell GE stock, you were forced to work with a broker that was a member of the New York Stock Exchange, and do the trade at the New York Stock Exchange; a single execution, clearing and settlement venue. Clearly, technology showed us ways in which we could find liquidity in multiple execution venues, such as Electronic Communication Networks, or ECNs. This breakup of the monopoly of execution, clearing and settlements lowered costs, increased liquidity and expanded the markets. This has evolved over time to break the listed-exchange trading and open the market to multiple trading venues.

Granting a trading and clearing monopoly to the stock exchanges was wrong. Today, GE shares can be traded on any number of exchanges, reducing costs and increasing competition, while the trades themselves are reported into the clearing and settlement systems. Although well intentioned, mandating the OTC market to migrate towards a specific contract on a specific exchange would be a step backward with little positive impact to the marketplace.

Exchanges have also had little success in responding quickly and effectively with new products to meet customer demands. For example, a corporation making a debt offering who wishes to enter into a fixed/floating swap to hedge interest rate movements for very specific terms to meet financing needs. If the marketplace is required to go to standardized contracts, that issuer will either have to conform its offering to accommodate those terms, creating a gap between the specific risk and the available contract, or more likely, the corporation will wind up with unneeded risk and exposure.

Exchanges do not insulate participants from failure. There are numerous examples of failures and bankruptcies related to exchange trading. Barings was forced into bankruptcy because of unauthorized trading of exchange-listed contracts on the Singapore International Monetary Exchange and the Osaka Securities Exchange in 1992.

IDBs have always been on the cutting edge of innovation, from publishing US Treasury prices on “green screen” video terminals in the 1970s to developing systems for automation of trade processing and interactive trading systems in the late 1990s. The Interdealer OTC market benefits from this

experience in that we have managed the migration of products from voice-based price dissemination to screen-based and ultimately to electronic trading. Today, highly commoditized products are traded electronically and ICAP owns and operates two of the leading electronic OTC trading platforms.

The benefits of electronic trading are numerous, providing greater price transparency, streamlined and automated trade capture, affirmation and confirmation. Regulatory reporting is seamless. However, in order for these benefits to be fully realized, electronic trading needs to be adopted by many more groups in the OTC market and in more markets than we have at present.

The “turnkey” development of a completely new market infrastructure is unnecessary as the potential electronic trading systems are in place, have been used and can be extended. Significant implementation time of a new market infrastructure will incur a high level of risk, sacrificing liquidity at a time when the markets need it most.

The OTC market has evolved continually over the last 25 years alongside the exchanges and serves a vital role in creating transparent credit and capital markets. Standard exchange-traded contracts very rarely provide a perfect hedge for actual economic risk. These slight differences between a perfect hedge and the standardized contract used to simulate a hedge generate an imperfect hedge, and in fact can result in hundreds of variances to the original protection risk, potentially increasing the frequency of trades and generating multiple risk imbalances. By contrast, users of the OTC markets can use non standardized financial products like credit default swaps or interest rate swaps to hedge their risk more precisely and transfer part of that risk to other professional OTC market participants.

While the OTC markets have played a major role in global economic development and have been the hub of developments that benefit savers, investors, businesses and governments, we think their operation and effectiveness can be improved and ICAP favors changes to the regulatory framework supporting these wholesale financial markets.

ICAP welcomes the coming reform and we feel our goals of promoting competition, electronic trading, and clearing helps both our customers and ICAP, as lower costs and risks equals more volume for our company. ICAP has been a long–time advocate of clearing and the utilization of a central counter party model, more rapid trade confirmation and reconciliation, the elimination of reset risk, and portfolio compression.

Specifically, the regulatory response to current events needs to focus on expanding and enhancing the transparency of the already existing OTC market infrastructure and making it more robust in those areas where it is too fragile. Regulations should mandate – as the New York Federal Reserve

and others have been proposing – wider adoption of central counterparty give up and or central clearing for OTC derivative markets. A central counter-party together with central clearing that is independent of the trading platforms and does not limit available sources of liquidity for those markets should be mandated for all markets.

We would like our White Paper, titled The Future of the OTC Markets and written by ICAP's Group Chief Operating Officer Mark Yallop, to be included with this testimony as it describes ICAP's positions on strengthening the OTC markets, as well as the key points that we believe can improve the way the OTC markets operate.

I again thank the committee for allowing me to speak on this topic, and we look forward to working with the committee on building the bridge to a better marketplace.