Testimony

Before
The House Financial Services Subcommittee
On Capital Markets and Government Sponsored Enterprises

“Challenges Facing the U.S. Capital Markets
to Effectively Implement Title VII of the Dodd-Frank Act”

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Introduction

Thank you, Chairman Garrett, Ranking Member Waters, and members of the Subcommittee for providing this opportunity to participate in today’s hearing.

My name is Chris Giancarlo. I am Executive Vice President of GFI Group Inc. (“GFI”), an American business and employer that operates around the globe as a wholesale broker of swaps and other financial products. I am also the Chairman of the Wholesale Markets Brokers Association, Americas (the “WMBAA”), an independent industry body representing the world’s largest wholesale brokers operating in the North American wholesale markets across a broad range of financial products. I am testifying today on behalf of the WMBAA.

I welcome the opportunity to discuss with you issues related to the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

WMBAA member firms have generations of experience operating at the center of the global wholesale financial markets by aggregating and disseminating prices and fostering trading liquidity for financial institutions around the world. Each business day, wholesale brokers, sometimes called “inter dealer” brokers, are busy facilitating the execution of hundreds of thousands of transactions corresponding to an average of $5 trillion in size across the range of foreign exchange, interest rate, sovereign, U.S. Treasury, credit, equity, and commodity asset classes in both cash and derivative instruments.

WMBAA members assist institutional clients in transacting both exchange-listed and unlisted products. They also operate trading platforms for instruments that are traded “over-the-counter” (“OTC”) such as swaps and other derivatives. They support financial markets by gathering and spreading bids and offers and completing trades as trusted intermediaries.

Importance of U.S. Competitiveness in a Global Market

In the past four years, trading in both exchange-traded and OTC equity and fixed income derivatives has declined substantially. With futures and swaps markets trading at a cyclical low, opportunities are reduced for hedging risk. U.S. lending and investment have similarly decreased, as seen in the pared extension of credit by American banks and sharply lower trading volumes on U.S. stock exchanges.

Further, Asian and European capital markets are competing with New York and Chicago for trading liquidity and customers. WMBAA members are concerned that certain trading is moving away from U.S. trading counterparties and U.S. markets. Certain proposed regulations restrict U.S. market participants from utilizing the full range of services provided by knowledgeable and neutral intermediaries to find trading partners in products in which liquidity is scarce and pricing is wide. U.S. market participants will be placed at a disadvantage as compared to foreign trading.

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1 The five founding members of the WMBAA are BGC Partners, GFI Group, ICAP, Tradition, and Tullett Prebon. The WMBAA was formed to promote the quality and standards of our industry and the role of wholesale brokers in world financial markets. For more information, please see www.wmbaa.org.
firms that can use such services, and certain capital markets will move away from the United States.

The United States needs healthy financial markets, including sound, transparent, and liquid swaps markets. Instead of furthering the growth of U.S. swaps markets, regulatory uncertainty is impeding recovery, and several proposed rules would impose practices that are incompatible with the efficient trading of swaps in the United States. Such rules are causing a restructuring of the U.S. swaps marketplace and the roles, risks, and rewards of its participants. As a result, the implementation of the Dodd-Frank Act will be protracted while swaps markets, and U.S. capital markets generally, remain in confusion, hindering American economic revival and job creation.

**Proposed SEF Rulemakings**

Regulators are currently in the process of drafting detailed regulations related to swap execution facilities (“SEFs”). Chairman Gensler recently reached out to entities that are expected to seek registration as SEFs, including the members of the WMBAA. He indicated that he has distributed draft final SEF rules to his fellow Commissioners, which may be finalized in the coming weeks or months. He further indicated that the final rules can be expected to be changed to ensure that all modes of trade execution through a SEF can be undertaken “through any means of interstate commerce,” so long that it can be verified that it is a true intermediated trade and not just a one-to-one negotiated transaction. The members of the WMBAA welcome this effort to align the regulations with the statute. By doing so, the rules would permit a wider array of modes of execution, including voice execution.

However, it is our understanding that these essential changes are only addressed in the “preamble” to the rule and not in the regulation itself. The rule text, Section 37.9, which will be relied upon as the law of the land, is reportedly silent on this point. If adopted, the CFTC would promulgate a rule that is inconsistent with the Dodd-Frank Act and contrary to the hundreds of comment letters filed, which would seriously handicap U.S. financial markets to the benefit of our international competitors. The CFTC must be clear and unambiguous in the final regulations that “any means of interstate commerce,” including voice, is permitted for SEF execution of all swaps.

We have waited nearly 24 months for final rules since the initial proposals were first published for public comment in January 2011. Let there be no question: the WMBAA supports the CFTC and SEC in finalizing SEF rules, as it will allow U.S. swaps markets and their customers to finally proceed with business under a clear regulatory framework that has been unknown for over two years. However, those rules must take into account the statutory provisions of the Dodd-Frank Act and honor Congressional intent. We remain hopeful that comments received from market participants and policy makers will assist the SEC and CFTC in formulating final rules that track the law and promote competition and transparency in U.S. financial markets.

The WMBAA stands for a swaps regulatory regime that improves regulatory transparency, promotes competition, and increases market participant access. We have supported the clearing, execution, and regulatory reporting mandates of the Dodd-Frank Act through dozens of public writings and formal Congressional and regulatory testimony. We continue that support today.
These rules will impact not only the large banks and swap dealers that make markets in swaps or the hedge funds that trade them. These rules will also impact American businesses and end users that use swaps to lessen their balance sheet risk to better manage their capital for growth and their ability to invest in jobs. In other words, these rules will affect not only Wall Street, but the economic conditions on Main Streets across the country and around the world.

We are, however, concerned that certain proposed SEF provisions are overly prescriptive, may harm market liquidity, increase trading costs, and drive trading in some swaps products offshore.

It is critically important that the CFTC and the SEC implement the key swaps reforms of the Dodd-Frank Act, including central clearing, regulated execution, and enhanced transparency, with balance and proportion. Regulators should adopt a flexible, principles-based approach that respects the importance of these markets to U.S. economic recovery and provides SEFs with reasonable discretion to develop and implement appropriate rules to carry out their obligations.

**WMBAA Suggestions Regarding the Proposed SEF Rule**

As noted in the WMBAA’s various comment letters to the CFTC, the WMBAA has identified the following as highest priority areas for attention.

**Permit Multiple Modes of Trade Execution, Including Voice Execution.** The SEF definition in the Dodd-Frank Act makes clear that trade execution through a SEF is permitted “through any means of interstate commerce.” Congress was unambiguous that multiple modes of trade execution are permitted for clearable swaps made available for trading, so long as post-trade capture and reporting can be done electronically.

This approach is consistent with the many methods of trade execution utilized by WMBAA members in global markets today, including: electronic, central limit order book platforms; request for quote systems (“RFQ”); electronic work up features; electronic matching and auction-based trading sessions; traditional voice execution; and a combination of voice and electronic systems (“hybrid systems”). Congress clearly demonstrated its appreciation of this market structure through the plain language of the statutory text, the iterations of the SEF definition which resulted in the final language, and the numerous meetings with WMBAA members and Congressional staff.

The CFTC’s proposed SEF rule, in Section 37.9, however, would: (1) restrict modes of swap execution for cleared, non-block transactions to solely two “means of interstate commerce”—central limit order book and RFQ; and (2) permit voice-based systems only with respect to block trades and certain other illiquid or bespoke swap transactions.

As a preliminary matter, block trades should not be tied to modes of execution. Though the CFTC’s proposed SEF rule defines the terms “Permitted” and “Required” transactions according to, in part, whether they are block trades, the statutory text of the Dodd-Frank Act does not tie block trades to modes of execution. Rather, the statute references block trades in terms of delayed public dissemination of certain trades of size.
The restrictions in the CFTC’s proposed rule would contravene the explicit language of the statute. This approach would inappropriately impair markets that rely on voice-based or hybrid systems by hindering the creation of liquidity and unnecessarily frustrating market participants. As WMBAA members provide both pre- and post-trade transparency regardless of execution method, such limitations on customer choice are not needed to enhance regulatory and market transparency. WMBAA members fully support requirements that all transactions of any means be subject to a complete time-stamped audit trail of the process of the trade for purposes of regulatory supervision.

Accordingly, the CFTC should clarify in its final rule that “any means of interstate commerce” includes the full range of swaps execution methodology, expressly including voice execution.

Remove the “15 Second Rule.” A 15 second timing delay before a trader can execute against a customer’s order, or a SEF can execute two customers against each other, is not contemplated by the Commodity Exchange Act (“CEA”), as amended by the Dodd-Frank Act, nor is it supported by legislative history. This concept will create uncertainty and risk in the market and jeopardize the CFTC’s balance of the need for pre-trade transparency with the market’s liquidity needs.

Further, this requirement does not appear to be consistent with the protection of investors. A broad range of financial market participants, including asset management firms acting within their statutory fiduciary duty to America's state and local government pension funds, endowments, ERISA funds, 401(k) and other retirement funds, have voiced their opposition to this requirement.

The 15 second delay ignores the unique nature of the swaps markets and will have a detrimental impact on liquidity. The CFTC, therefore, should remove the “15 second rule” and allow flexibility suited to the quality of liquidity in a given instrument.

Clarify that Impartial Access Extends to Market Participants Only. The CFTC should delete the provision in the proposed rules providing impartial access to SEFs for independent software vendors (“ISVs”). This requirement is beyond the legal authority granted in the CEA and expands the impartial access statute beyond “market participants” to include entities lacking any intent to transact in swaps. Further, the rule fails to clearly define what constitutes an ISV.

The proposed rules might allow competing SEFs to qualify as ISVs and have unfair access to competitors’ systems or platforms, producing a result contrary to the Dodd-Frank Act’s goal of promoting a thriving marketplace of competing swap execution venues. The resulting competitive harm to SEF registrants is unwarranted. There is no congressional intent or legislative history to indicate that the term “market participants” should be read beyond the commonly understood definition as used by the industry today.

Withdraw the DCM 85 Percent Volume Requirement. The CFTC has proposed amendments to designated contract market (“DCM”) Core Principle 9 that would establish a minimum on-exchange trading threshold of 85 percent. The proposed rule would not assure price improvement or materially enhance pre-trade price transparency. Rather, it would create
unnecessary market disruption and increase trading costs. In place of the proposed rule, the
CFTC should adopt a flexible approach that takes into account available trading liquidity and
favors customer choice of venue and mode of swaps execution.

CFTC Cross-Border Interpretive Guidance

In addition to the SEF rules, the CFTC’s other proposed rules have had troubling extraterritorial
impacts as well. In fact, the “interpretive guidance” approved by the CFTC in June of this year
received tremendous international criticism and resulted in real-world harm to many U.S. firms.
In particular, the guidance included an expansive proposed definition of the term “U.S. person,”
and described the manner in which the Commission proposed to consider whether a non-U.S.
person is a swap dealer or major swap participant. The proposed guidance also interpreted a
provision of the CEA regarding activities with a “direct and significant connection with activities
in, or effect on, commerce of the United States.”

Let me be more specific. We are pleased to note that global regulators met recently in New York
and pledged to harmonize their regulatory reform efforts. We wish them success. Nevertheless,
from our perspective as operators of global trading platforms, we are currently observing that
U.S. trading firms are being shunned by foreign counterparties in order to avoid having to
register with the CFTC as swap dealers. For example, Singapore’s DBS Group and Sweden’s
Nordea Bank are the first major institutions to publicly declare that they would not register with
U.S. regulators to trade swaps. Additional firms have indicated a similar preference in private
and have ceased trading with U.S. persons. In terms of the interest rate swaps market in Asia, a
“two-tiered” market appears to be developing in response to the proposed U.S. extraterritorial
regulations. Through pre-trade requests, certain Asian banks are declining to transact with U.S.
counterparties located anywhere, while others are willing to trade with a U.S. counterparty
located in a foreign office but not a U.S. counterparty located in the United States. All of these
Asian banks have indicated the intention to avoid being ensnared in the CFTC’s
extraterritoriality rules.

In light of these developments, if the CFTC regulation is promulgated as proposed, U.S. firms
will be placed at a significant disadvantage in the event of a market crisis. Under the current
CFTC proposed guidance, the market tier that excludes U.S. persons will not be subject to CFTC
regulations and will be able to execute trades through the full spectrum of hybrid brokerage

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2 The CFTC’s proposed definition of the term “U.S. person” would include, but not be limited to: (i) Any natural
person who is a resident of the United States; (ii) any corporation, partnership, limited liability company, business or
other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing, in each
case that is either (A) organized or incorporated under the laws of the United States or having its principal place of
business in the United States ("legal entity") or (B) in which the direct or indirect owners thereof are responsible for
the liabilities of such entity and one or more of such owners is a U.S. person; (iii) any individual account
(discretionary or not) where the beneficial owner is a U.S. person; (iv) any commodity pool, pooled account, or
collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a
majority ownership is held, directly or indirectly, by a U.S. person(s); (v) any commodity pool, pooled account, or
collective investment vehicle the operator of which would be required to register as a commodity pool operator
under the CEA; (vi) a pension plan for the employees, officers, or principals of a legal entity with its principal place
of business inside the United States; and (vii) an estate or trust, the income of which is subject to United States
income tax regardless of source.
trading methods, including voice brokering. Conversely, the tier that includes U.S. persons as counterparties will be severely limited in modes of execution, including using voice execution that is vital during periods of market disruption or financial panic. During any such market crisis, liquidity will move to the market tier that excludes U.S. persons where counterparties will be free to access voice brokers to hedge their positions while U.S. traders and firms will be at risk and unable to access liquidity.

“Futurization of the Swaps Market”

I would like to alert you to another development with great implications for the health of U.S. capital markets. Immediately upon the October 12 effective date for certain CFTC regulations, we observed an overnight migration of trading activity in U.S. natural gas and electric power markets from cleared swaps to economically equivalent futures products. In itself, this event was unprecedented in that a vital U.S. market changed its entire trading activity largely to avoid pending regulatory structure rather than for significant commercial or economic advantage or public good. More broadly, however, it suggests even greater migration and potential disruption to U.S. capital markets if replicated in other swaps products. We fear all of this is happening with very little study and oversight by the regulators on these new and game-changing products.

As members of this Subcommittee know, in crafting Title VII of the Dodd-Frank Act, Congress established a swaps regulatory structure that would reduce systematic risk, promote central counterparty clearing, increase transparency, and preserve competitive U.S. markets for swaps trading. Congress, however, did not mandate a preference for futures products over swaps or monopolistic silos for trading and clearing over competitive multi-venue trading platforms and fungible clearing.

Notwithstanding the clarity of Congress’s intention, the CFTC has furthered regulatory arbitrage against one product under its jurisdiction—swaps—in favor of the other—futures. The opportunity for arbitrage between swaps and futures results from a range of factors, including differences in the calculation and setting of block trade sizes, timing of trade reporting, tax treatment, counterparty registration, cross-border trading, business conduct rules, and, importantly, the cost of margin and capital that will create inexplicable and potentially systemically dangerous differences in the treatment of managing identical risks in different markets. While the migration resulted from the combination of these arbitrage factors, the primary impetus came from the desire of U.S. non-bank energy traders to avoid cleared swaps trades from being counted toward a numeric threshold that would force them to register as “swap dealers” or “major swap participants.” Taking advantage of the current uncertainty as to the timing and substance of final swaps rules and exploiting the above arbitrage opportunities, futures exchanges are rolling out a series of swap future products that are economically equivalent to swaps, but allow market participants to avoid swaps regulation entirely.

All of this is happening while WMBAA member firms, and other companies with experience fostering liquidity, wait patiently for the CFTC to complete its SEF rules. It is nearly two years since publication of the proposed rule, and our companies cannot begin to operate under the new Dodd-Frank Act regime until these regulations are adopted. Until then, we remain at a regulatory disadvantage simply because there are no final rules. While we wait, confusion reigns
among our customers whose market making activities are vital to U.S. capital markets and American prosperity.

The “Futurization” of Swaps Markets Harms Competition. Today, the U.S. swaps market offers a broad choice of financial products, methods of trade execution, trading venues and clearinghouses. Under the Dodd-Frank Act, Congress wisely enhanced the competitive nature of the swaps market by mandating impartial access to swaps clearing, thereby assuring product fungibility. The U.S. futures market, while working very well for a finite set of highly liquid commodities and financial products, restrains competition by limiting methods of execution and having single vertical silos for execution and clearing.

Unlike SEFs, exchanges control the size of block trades for futures contracts and deny impartial access to clearing. This allows exchanges to limit their customers’ choice of execution venue. The U.S. Department of Justice has deemed the structure of the U.S. futures market to be one marked by vertical monopolies. The unabated “futurization” of the swaps market entrenches the vertical monopolies of the futures industry and thwarts Congress’s envisioned landscape of competing SEFs and impartial access to swaps clearing. The movement of trading from swaps to futures is a movement toward monopolistic control, reduced customer choice and, inevitably, higher costs of trading and execution. The result will reduce the competitiveness of U.S. capital markets against foreign competitors.

The Dodd-Frank Act rejected the vertical silo model for the swaps market in favor of a market place with competitive clearing, execution, and trade reporting, ensuring that derivatives clearing organizations (“DCOs”) would not use that central role to act in an anti-competitive manner. The statute goes further and ensures that DCOs provide “nondiscriminatory access to clearing” for trades executed on a SEF because SEFs will compete with affiliates of the DCOs. These protections do not exist in the futures market.

The “Futurization” of Swaps Markets Does Not Improve Transparency. 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 in real-time to the public and to licensed swap data repositories. Additionally, it requires swap dealers and major swap participants to register with regulators, assuring direct trading supervision and accountability. In contrast, there is no statutory mandate for the real-time reporting of futures trades to the public or to registered data repositories, nor is there any requirement for the direct registration, supervision, and accountability of traders of futures products. As a result, the migration of swaps markets to futures products will not enhance market transparency, contrary to the Congressional objective set forth in the Dodd-Frank Act.

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5 Notwithstanding the Dodd-Frank Act's rejection of vertical monopolies in trading of swaps products, there are still issues of monopolistic practices. CME's proposed rule 1001 would require that swaps cleared by its clearing house be reported to CME's affiliated swap data repository (“SDR”) notwithstanding customer preference to report to a competing SDR.
The “Futurization” of Swaps Markets Increases Balance Sheet Risk for Market Participants. Swap futures are imperfect hedges that will cause market participants to incur basis risk. Swap futures do not allow for specific exercise dates, unlike swaps which are infinitely customizable. If a corporation is forced to use futures rather than cleared swaps (whether by regulatory fiat or lack of swaps liquidity), the non-availability of specific exercise dates may create basis risk for the company and make it ineligible for hedge accounting treatment. The result would be greater earnings volatility. Further, upon expiration of swap futures contracts, market participants may be forced to “roll” expiring contracts into new contracts to maintain their hedging, exposing them to additional market risk. This would lead to more volatile markets, especially in times of market uncertainty and crisis.

The “Futurization” of Swaps Markets Also Lessens Customer Protections. With cleared swaps, a customer of a given Futures Commission Merchant (“FCM”) is protected from the risk that a second customer of the same FCM will go bankrupt causing the FCM to fail, which would draw the first customer’s funds into the liquidation. This segregation of one customer’s margin from another is only available for cleared swaps and not for futures. By migrating cleared swaps to futures, the customer is deprived of the protections that were specifically included in the Dodd-Frank Act.

The “Futurization” of Swaps Market Increases Systemic Risk. The CFTC has determined that DCOs must utilize a one-day liquidation time horizon for futures and a five-day liquidation time horizon for most swaps. Labeling a product as a “future” and listing it on a DCM results in more favorable margin treatment over a product called a “swap” even though the economic characteristics of such products may be identical. The name of a product’s execution venue (e.g. DCM or SEF) should not impact the margin requirements of two economically similar cleared instruments. Instead, that calculation should be based on observable market conditions of liquidity and volatility. By holding lower margin for a swap future with the exact same risk as its economically equivalent swap, clearinghouses are forced to absorb more risk, especially during a liquidity crunch or a downgrade of its clearing members. Instead, products brought to the market as futures should have the same margin, tax treatment, and reporting requirements as swaps managing the same risk.

As the “futurization” of the swaps markets harms competition and transparency and increases balance sheet and systemic risk, we call on regulators, legislators, and policy makers to provide thorough research-based market analysis and customer-based supervision. This development is overwhelmingly driven by regulatory arbitrage rather than a commercial opportunity, and would allow market participants to select one regulatory framework over another for economically equivalent products. Such a market switch should not be permitted due to regulatory omission. Regulators must take full charge and responsibility for the development and the resulting unintended consequences.

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Conclusion

The WMBAA understands that the CFTC Commissioners are considering a draft set of final rules related to SEFs, block trading, “made available to trade,” and extraterritoriality, which include significant modifications from the initial proposed rules. The SEF rules must make clear—in the rule itself and the preamble—that trades can be done “through any means of interstate commerce.” The rules should dispense with the so-called “15 Second Rule,” which would harm swaps market liquidity without benefitting market participants or market safety. The rules should also withdraw the 85 percent threshold for DCM Core Principle 9, which would diminish trading liquidity and limit customer choice of mode and execution venue.

Once these SEF rules are approved by the Commissioners and published in the Federal Register, the WMBAA members will navigate the process of compliance with the various rules, including requirements for registration, trade execution, block trading, margin setting, and trade reporting.

The final rules must be designed and implemented in a manner that helps to preserve the existence of sound, efficient, liquid, and more transparent financial markets. In this regard, the final rules must be consistent with the plain language of the Dodd-Frank Act, as deviations from the statutory text will hinder the growth of efficient capital and financial markets that are essential for the nation’s recovery.

We call on the CFTC, the SEC, and non-U.S. financial market regulators to continue their crucial work to harmonize global regulatory reform efforts. As global intermediaries that operate across international markets, we sound the alarm regarding the development of two-tiered markets—one that includes U.S. counterparties and another that excludes U.S. counterparties—solely on the basis of avoiding overly restrictive U.S. regulations. As this development will be detrimental for U.S. trading interests and for the U.S. economy, policy makers must be vigilant to prevent its further growth.

Finally, we call on regulators and policy makers, including members of this Subcommittee, to give full and effective consideration to the “futurization” of the swaps markets, the harm it will cause to competition and transparency, and the risk it will incur to corporate balance sheets and U.S. capital markets. Such a migration of markets should not be driven merely to avoid one regulatory framework without a thorough, research-based understanding of the likely consequences.

Thank you for the invitation to participate in today’s hearing.