

Statement for the Record of the Investment Company Institute
Hearing on “Emergence of Swap Execution Facilities: A Progress Report”

Subcommittee on Securities, Insurance and Investment
Committee on Banking, Housing and Urban Affairs

U.S. Senate

June 29, 2011

The Investment Company Institute very much appreciates the opportunity to submit testimony to this Subcommittee and offer our perspectives on certain aspects of the development of swap execution facilities (“SEFs”). ICI is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts (collectively, “funds”).¹ Members of ICI manage total assets of \$13.41 trillion and serve over 90 million shareholders.

The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) will dramatically change the derivatives markets, establishing a regulatory framework for the swaps markets and their participants.² Funds are participants in these markets, using swaps and other derivatives in a variety of ways to manage their portfolios.³ Accordingly, ICI and its members have encouraged reform efforts in these markets,⁴ including by urging the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”;

¹ Throughout this testimony, references to “funds” and the “fund industry” refer only to those funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940.

² Throughout this testimony, we will use the term “swaps” to refer to both swaps and security-based swaps.

³ For example, funds use derivatives to hedge positions; equitize cash that a fund cannot immediately invest in direct equity holdings; manage the fund’s cash positions more generally; adjust the duration of the fund’s portfolio; or manage the fund’s portfolio in accordance with the investment objectives stated in its prospectus.

⁴ Testimony of Karrie McMillan, General Counsel, Investment Company Institute, before the Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, United States House of Representatives, on “Implementing Dodd-Frank: A Review of the CFTC’s Rulemaking Process” (April 13, 2011) and Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of Representatives Committee on Financial Services on “Industry Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals” (July 17, 2009), available at http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny.

together, “Commissions”) to promulgate regulations in a manner that provides the protections sought by the Dodd-Frank Act while minimizing disruptions to the markets, market participants, and customers.⁵

Pursuant to Title VII of the Dodd-Frank Act, swaps subject to the new mandatory execution requirement will be permitted to be traded on SEFs as well as on designated contract markets (“DCMs”). As execution facilities, SEFs will be one of the avenues through which funds determine whether and how to interact in the swaps market. The appropriate regulation of SEFs and their role in the new regulatory structure will be critical to ensuring transparency, price efficiency, liquidity and stability in the swaps markets.

Investor Representation on SEFs

As participants in the swap markets, funds have a strong interest in ensuring that these markets are highly competitive, transparent, and efficient, and operate in a manner that treats all market participants fairly. To that end, SEFs should include investor representatives on their boards of directors. Requiring investor representation in the governance structure of a SEF minimizes conflicts of interest by better balancing the advancement of commercial interests with the fulfillment of self-regulatory responsibilities. Conflicts of interest that may exist include: limiting SEF membership to minimize risk exposure and preserve the swap entity’s profits; limiting the scope of products eligible for clearing, particularly if there is a strong incentive to keep a product traded in the OTC market; and maintaining lower risk management controls to reduce the amount of collateral and liquidity that the SEF’s members are required to post. A regulatory structure that aids in controlling these conflicts of interest should help prevent a SEF from putting its interests and those of its members⁶ ahead of its regulatory responsibilities by failing to take necessary action or appropriately manage risk exposure. It also should, in turn, reduce systemic risk in the swap markets. In addition, investor representation would level the playing field for SEFs by creating a governance structure wherein SEFs operate under similar restraints on the influence of owner and member self-interests, which would benefit new SEFs in the market.

In addition to board representation, we strongly support investor representation on board advisory committees, including swap review committees.⁷ These committees are designed to facilitate meaningful discussion on important issues before the board. Such advisory committee representation, however, should not be a substitute for investor representation on the board itself. This is particularly

⁵ The Dodd-Frank Act was enacted to reduce risk, increase transparency, and promote market integrity within the financial system.

⁶ For purposes of this letter, “members” refers to members, participants, and enumerated entities as used by the Commissions in their proposals.

⁷ Both the New York Stock Exchange and the Nasdaq Stock Market, for example, have board advisory committees composed of institutional investors, *i.e.*, the NYSE Institutional Traders Advisory Committee and the Nasdaq Quality of Markets Committee.

true in the developing swap markets where, at this time, investors have access to only a handful of venues for clearing and trading.

Preserve Flexibility of Trading on SEFs

The SEF provisions in the Dodd-Frank Act are designed to encourage swap trading on SEFs by providing a flexible execution framework. To achieve this goal, implementing regulations must strike an important balance between transparency on the one hand and the necessary flexibility to encourage use of the SEFs on the other. We are concerned, however, that the trading restrictions in the SEC's and CFTC's SEF-related proposals would hamper the migration of swaps to the cleared and SEF-executed market by enhancing transparency at the expense of liquidity and efficient pricing.⁸ In particular, ICI is concerned about the CFTC's prescriptive requirements regarding the request for quote ("RFQ") process and the SEC's requirement to interact with bids and offers resting on the SEF.

The RFQ Process

ICI supports the Commissions' proposed use of RFQ systems for the execution of swaps but questions the CFTC proposal to require that a RFQ be sent to five or more dealers. If a fund is required to go to five swap dealers prior to executing a swap transaction, it likely would suffer from information leakage and "signaling" regarding the potential transaction. Each of the five dealers would know that four others are also being approached about the same deal. Such a situation could increase the potential for front running and make it likely that the price of the swap would move against the fund, resulting in the dealer paying a higher price for the second side of the transaction. In other words, market participants, including the five RFQ dealers, would adjust their trading activity based on information in the RFQ, thereby moving the market price. This higher price would be borne by funds and their shareholders in the form of a wider bid-ask spread.

To eliminate concerns about information leakage or diminished liquidity, market participants should be provided with the flexibility to structure their RFQs on whatever basis they believe will serve their customers' interests, regardless of the number of providers they reach out to. Market participants should be permitted to enter swap transactions with the counterparties of their choosing. For example, given their legal and fiduciary duties, ICI believes that fund managers are well suited to determine the appropriate number of dealers in which to send a request. Moreover, there may be circumstances when trading swaps with low liquidity or volume in which five liquidity providers are not available; those available are not creditworthy; or those available do not satisfy various legal requirements. We therefore recommend that the CFTC consider the SEC's proposal, which would require that a SEF allow for market participants to disseminate an RFQ to one or more swap dealers.

⁸ See CFTC Release, *Core Principles and Other Requirements for Swap Execution Facilities*, 76 FR 1214 (January 7, 2011), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-32358a.pdf> and SEC Release No. 34-63825, *Registration and Regulation of Security-Based Swap Execution Facilities*, 76 FR 10948 (February 28, 2011), available at <http://www.sec.gov/rules/proposed/2011/34-63825fr.pdf>

Interacting with Bids and Offers

The SEC should eliminate the proposed requirement for market participants to interact with resting bids or offers. The SEC proposal would impose a price-time priority model on swaps executed on SEFs. Specifically, the SEC proposal would require that a SEF that allows participants to display firm quotes must be designated so that all trades, including those to be executed through the RFQ process, first interact with pre-existing resting bids and offers available at an equal or better price. This requirement to trade with better priced existing bids and offers raises several concerns, including nullifying the RFQ process and thereby hindering funds' execution strategies and objectives. Further, when considering the factors in addition to price that are a part of the calculation for the quality of swap execution, a higher priced bid or offer may not, in fact, be a better price for completion of the transaction. To the contrary, requiring a fund to break up its notional order to interact with a resting bid or offer could result in multiple trades instead of a single execution. This fragmentation of orders could result not only in higher transaction costs to funds and their shareholders but also additional reporting and margin costs for each transaction.

Consistency Between SEC and CFTC SEF Trading Restrictions

As discussed above, the SEC's and CFTC's proposed SEF trading restrictions vary significantly. A uniform approach to their respective rules is necessary to minimize operational difficulties for market participants, control for costs related to the new trading environment, and ensure that the final SEF rules accommodate flexible execution requirements that encourage trading on SEFs. For example, trading of all types of credit default swaps ("CDS") may occur on a fund's fixed-income desk. However, a CDS on a single security or narrow-based index would be subject to the SEC's SEF rules while a CDS on a broad-based index would be subject to the CFTC's SEF rules. Traders, operational and legal and compliance staff will be faced with the difficult task of ensuring application of the proper rule set, including compliance and risk policies and procedures, within the context of potentially rapidly trading swaps. In the absence of coordination between the CFTC and SEC on their SEF proposals, we therefore are concerned that the proposed SEF rules would be disruptive to the swaps markets and adversely affect execution quality.

Reporting of Swap Transaction Data and the Identification of Block Trades by SEFs

Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals that would require, upon execution, reporting of swap transaction data to a registered swap data repository ("SDR").⁹ The SDR would make certain of the swap data publicly available in real time. Market

⁹ See CFTC Release, *Real-Time Reporting of Swap Transaction Data*, 75 FR 76139 (December 10, 2010), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-29994a.pdf> and SEC Release No. 34-63346, *Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information*, 75 FR 75208 (December 2, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-63346fr.pdf>.

transparency is a key element to ensuring the integrity and quality of these markets,¹⁰ but ICI has several concerns with the proposals as they relate to block trades, and ultimately SEFs. To address these concerns, we have recommend that in each of their proposals the SEC and CFTC should (1) define a block trade by evaluating the market for a particular swap category to determine what might be an illiquid size and (2) ensure that SEFs can qualify as the reporting party in SEF-executed transactions. We also recommend that the Commissions harmonize and coordinate their proposals to the extent possible.

Block Trades and SEFs

Block trades enable funds, on behalf of their shareholders, to efficiently transact in large amounts off an exchange with minimal disruption to the swaps market. As with other swap transactions, block trades in swaps subject to clearing requirements under the new swaps regulatory framework will be required to be traded on DCMs or SEFs. This means that in addition to the regulatory and public reporting obligations in the SEC and CFTC proposals, block trades will be subject to the SEF trading restrictions discussed above. For both of these purposes, it is critical that the Commissions identify the appropriate thresholds for block trades in the swaps markets to avoid significant disturbance to and negative implications for the swaps markets, participants and customers.

The CFTC has proposed to exempt block trades from the requirement to trade on a SEF. A SEF would still be required to process the block trade upon receipt of transaction data by the reporting party but the fund's trading strategy would not be dictated by the proposed SEF trading rules. The key to this exemption, however, is the threshold for block trades. If the CFTC adopts thresholds that do not recognize the liquidity of the various swaps markets, trades that otherwise should be block trades will still be required to trade on a SEF with all of the concerns discussed below.

After a block trade has been executed, one or more of the counterparties will seek to reduce risk by hedging its exposure, usually by transacting on an exchange. Knowledge of a block trade therefore signals to other market participants that there is the potential for subsequent trading activity.¹¹ This

¹⁰ As part of its recommendations to the SEC and CFTC regarding the sequence for implementation of the new swaps regulatory framework, ICI has recommended that the Commissions begin by finalizing and implementing rules requiring reporting of swap transaction data to the regulators. Initially, reporting should be limited to non-public, regulatory reporting to gather data to inform regulations, for example, on block trading without significantly disrupting the swaps market and market participants' trading strategies by impacting liquidity. ICI believes that the information gathered through this process will assist the Commissions in better understanding the structure and operations of the swaps markets and adopting appropriately tailored and effective rules. Further, only after such analysis can the Commissions accurately determine the effect of public dissemination of certain of the swap transaction data. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated June 10, 2011 (commenting on phase-in schedule for requirements for Title VII of the Dodd-Frank Act), available at <http://www.ici.org/pdf/25276.pdf>.

¹¹ In post-transaction analysis of block trades, our members report being able to see that the market tracked their movements.

signaling can negatively affect the market and fund shareholders by significantly skewing pricing if the market does not have sufficient time to digest the block order. In addition, opportunistic market participants may piece together information about a fund's holdings or trading strategy, leading to front running of a fund's trades, which also adversely impacts the price of the swap and the underlying asset to the detriment of fund shareholders.

Flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity. The ideal way to identify the appropriate thresholds for block trades in the swaps market is to account for the liquidity in each unique category of swaps.¹² The risks, trading and liquidity associated with a particular swap differ for each individual swap category within an asset class based on type, term and underlying security.¹³ The SEC and CFTC should reflect these granular but significant differences by creating narrow buckets to which the threshold formulas would apply.¹⁴ These thresholds should be calculated regularly (*e.g.*, quarterly) to ensure that they are appropriately tracking liquidity in the swap categories.

In any event, however, the thresholds must be low enough to encourage the use of block trades. Setting the thresholds too high could result in fund managers breaking up large size trades to minimize the possibility of information leakage and front running, which could cause market disruption and additional costs to fund shareholders. Further, the Commissions should err on the side of caution by setting the thresholds low initially to collect data from SDRs to enable them to evaluate the thresholds and determine the appropriate delays for data dissemination.

Reporting Party

The SEC and CFTC proposals take different approaches to identify the proposed reporting party for a swap transaction. Under the CFTC proposal, the reporting requirement would be satisfied if a swap is executed on a SEF. The SEC proposal establishes a hierarchy that identifies the reporting party to a swap transaction. Within this structure, the SEC proposal would permit a reporting party to enter into an agreement with a third party to report a swap transaction on behalf of the reporting party. In this way, a security-based SEF could transmit a transaction report for the swap to a registered SDR.

¹² Under the proposed CFTC thresholds, many transactions that should be treated as block trades would not qualify as such. The SEC proposal does not include thresholds. Instead, the SEC seeks comment on the general criteria that should be used by SDRs to determine whether a transaction is a block trade.

¹³ The SEC proposal states that it would be inappropriate to establish different thresholds for similar instruments with different maturities. We strongly disagree because of the unique characteristics associated with each swap.

¹⁴ The CFTC has proposed a two-test model to determine the minimum block trade threshold, with the larger result from the test being the applicable threshold. The "distribution test" would provide that 5 percent of swaps in a category would be block trades, based on transaction sizes over the prior calendar year. The "multiple test" would provide that a block trade is one that is larger than the largest of five times the mean, median and mode of transactions in the category of swaps over the prior calendar year. We recommend that the CFTC eliminate the "multiple test" from its proposal and, instead, implement a modified "distribution test" based on factors including, among others, product, liquidity and tenor.

ICI believes this extra step is unnecessary and burdensome. Absent an agreement by the parties to pursue an alternative reporting regime, a transaction executed on a SEF should be reported by that SEF.

Consistency between CFTC and SEC Reporting Requirements

As identified above, the SEC and CFTC proposals differ, sometimes substantially. The principles guiding the regulatory approaches and the underlying rules should be the same with respect to real-time reporting and SEFs. The approach to reporting should be uniform and consistent, reflecting the unique characteristics of the swaps market even though application of the final rules to the individual swaps within each Commission's jurisdictions should ideally differ in recognition of the liquidity for those products. Duplicative requirements are burdensome and inconsistent requirements pose the potential for operational, legal and compliance problems.

At a minimum, we recommend that the agencies coordinate their proposals with respect to reporting parties, reporting time frames, data to be reported, the approach to establishing block trade thresholds, and the time frames and data requirements for reporting block trades. Such coordination would be in keeping with the Dodd-Frank Act mandates and would help to minimize excessive and unnecessary regulatory burdens caused by differing regulatory requirements.

Conclusion

We appreciate the opportunity to share our views with the Subcommittee, and we look forward to working with Congress and regulators as they seek to address these many important issues involved in implementing the SEF related-provisions of the Dodd-Frank Act.