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Testimony of

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Insurance and Investment

re: "Emergence of Swaps Execution Facilities: A Progress Report"

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My name is Ben Macdonald and I am the Global Head of Fixed Income for Bloomberg L.P., a privately-held independent limited partnership headquartered in New York City. Bloomberg is not owned by any swap market participants and does not itself engage in trading of swap instruments on a proprietary basis. Our customer base for our information and news services, market analytics and data services, and for our platforms for electronic trading and processing of over-the-counter (OTC) derivatives is evenly distributed among buy-side and sell-side entities. We serve the entire spectrum of the financial market and, being independent, we do not have a bias towards nor are we beholden to any particular element of the market.

Bloomberg's core business is the delivery of analytics and data on approximately 5 million financial instruments, as well as information and news on almost every publicly traded company through the Bloomberg Professional service.¹ More than 300,000 professionals in the business and financial community around the world are connected via Bloomberg's proprietary network. Over 17,000 individuals trade on our system across all fixed income product lines alone, with over 50,000 trading tickets a day coming over that network. Virtually all major central banks and virtually all investment institutions, commercial banks, government agencies and money managers with a regional or global presence are users of the Bloomberg Professional service, giving Bloomberg extraordinary global reach to all relevant financial institutions that might be involved in swap trading.

I lead Bloomberg's team of professionals dedicated to establishing a registered Swaps Execution Facility (SEF) and Security-Based Swaps Execution Facility (SB-SEF)

¹ Bloomberg employs over 12,900 employees around the world, including more than 2,300 news and multimedia professionals at 146 bureaus in 72 countries, making up one of the world's largest news organizations

under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As the largest independent player in the market in terms of electronic trading and processing of OTC derivatives, Bloomberg has an extensive suite of capabilities, experience, technical expertise, infrastructure, connectivity and community of customers that uniquely position our firm to provide unbiased, independent intermediary SEF and SB-SEF services to both the buy-side and the sell-side in the domestic and international swaps market. All major swaps dealers utilize our platform. Over 600 firms use Bloomberg's existing platform to trade interest rate swaps and credit default swaps. We provide connectivity for both the buy-side and the sell-side to multiple clearinghouses. We facilitate exchange-traded as well as voice brokered swaps on our system.

Bloomberg fully supports the creation of the regulated swaps marketplace envisioned by Dodd-Frank. We believe that the Dodd-Frank mandatory clearing and reporting requirements will significantly mitigate systemic risk, promote standardization, and enhance transparency. We enthusiastically anticipate being a robust and capable competitor in the SEF and SB-SEF markets, and we believe our participation as an independently-owned firm will bring innovation, reliability, efficiency, transparency, and reduction of systemic risk to the markets.

Bloomberg's existing electronic swaps platforms: experience and innovative leadership

Our views on the subject of SEF² regulation are significantly informed by our long and successful experience derived from our existing OTC swaps trading platforms. We believe that body of expertise and experience provides Bloomberg the opportunity to

² Our reference to "SEFs" in this testimony is intended to include SB-SEFs as well unless otherwise indicated.

engage the new world of SEF registration and operation from a considerable position of strength. Our current OTC derivatives trading platforms were built on the idea of adding transparency to the market by creating electronic functions that streamline trading in swaps and provide efficient, competitive access to swaps pricing, all of which aligns very well with the goals of Title VII of Dodd-Frank.

Bloomberg's current "single-dealer" and "multi-dealer" derivatives trading tools allow multiple participants to view and trade swaps with multiple dealers. In Bloomberg's single-dealer page system, enabled participants are readily able to view different dealer pages (simultaneously if preferred) that display the price and volume at which each dealer has indicated it will trade. After reviewing the displayed prices a participant can then request to execute against a single-dealer page's displayed price with the understanding that the dealer can accept, counter or reject execution. Multi-dealer pages display a "composite price" reflecting the general market based on participating dealers' respective price submissions. After reviewing the displayed "composite price" a participant can request specific prices from 3 dealers. The participant then has a limited time to accept or reject a trade with any of the dealers. Under both models, Bloomberg provides real-time trade reporting to warehouses, data repositories and clearing venues.

Bloomberg also has hosted various "request for quote" (RFQ) systems for OTC derivatives for the past five years. These RFQ systems allow entities seeking liquidity to secure bids and offers from particular market participants they would like to engage in a transaction. Our Bloomberg Bond Trader System, a competitive multi-dealer RFQ platform for US and foreign government securities, has been active for more than 13 years. We are confident that these very successful RFQ models provide directly relevant

experience and are the proper conceptual paradigm for establishing a SEF under Dodd-Frank.

In addition to operating a very robust RFQ system, we also operate our “AllQ” system that shows market participants on one screen the stack of liquidity reflected in the range of streaming bids and offers from multiple dealers in the market. Users can perform their price discovery, and then click and trade with their dealer of choice.

Both our RFQ and our AllQ systems empower properly enabled market participants to hit on executable bids and offers, or engage in electronic negotiation with counterparties on indicative bids. Our experience and success with our RFQ and AllQ platforms provide us confidence that we will be able to satisfy the operational requirements established by Dodd-Frank for SEF registration. We intend to be prepared to begin SEF operations on the implementation date of the relevant SEF regulations issued by Commodity Futures Regulatory Commission (CFTC) and the Securities Exchange Commission (SEC), provided that the two regulators create synchronized rules governing trading protocols, board composition and financial reporting.

Responses to the Committee’s Specific Areas of Inquiry:

Bloomberg most certainly supports Dodd-Frank’s call for the emergence of SEF-style trading, increased mandatory clearing and post-trade transparency through reporting. In particular, Bloomberg is very supportive of the federal regulators providing clear and specific rules for clearing and post-trade transparency, which together serve as the most significant tools for reducing systemic risk and attaining a reformed, financially sound derivatives marketplace that benefits market participants and the nation as a whole.

The systemic risk threats that arose in 2008-2009 were associated with insufficient clearing and post-trade transparency and were not the result of execution failures. Indeed, market participants know very well what they want and need regarding fair and efficient execution on electronic platforms. Sophisticated market participants do not really need or want federal regulators micro-managing execution protocols; no one should expect that market participants will necessarily want to trade the way the federal government prefers that they trade. It is also not the proper role of the federal regulators to go to extravagant lengths to define the most favorable terms of execution for trading by sophisticated investors. Rather, while it is clearly a very important function, what is incumbent on federal regulators is only to insure that the market is fair and competitive and that participants themselves have enough information to assess whether they know that they are getting a fair price.

The risk that federal regulators run in micro-managing execution protocols is that they will increase the direct cost of trading—with no compensating benefit to customers—and impose significant constraints and indirect costs that incentivize market participants to revert to forms of trading that evade the excessive regulation and those costs. It will not be difficult for market participants to find wholly lawful ways to conduct their trading in non-SEF environments, including taking their trading to foreign jurisdictions where the US rules do not apply.

Consequently, we do not believe that the same degree of regulation warranted for clearing and post-trade reporting is desirable from a public policy perspective with regard to trade execution protocols. Rather, in providing rules on trading protocols, federal

regulators should specifically avoid over-regulation and imposing “one size fits all” mandates, but should instead use a principles-based approach which encourages flexibility by SEFs that will maximize their innovation, competition and responsiveness to the needs of the market. Failure to invest SEFs with the ability to employ flexibility in their trade execution protocols actually jeopardizes the realization of the public policy objectives that Dodd-Frank seeks to attain.

In his letter of invitation to this hearing, Chairman Reed outlined six specific areas of inquiry of interest to the Subcommittee. In response, Bloomberg offers the following views:

Question 1: What is the status of industry readiness for trading on SEFs? What in your view is the timeline for the movement of substantial volumes of derivatives activity onto SEFs? What, if any, documentation is necessary for market participants to migrate their trading activity onto SEFs?

There are different degrees of readiness for trading on SEFs among market participants and among products. Some market participants, including banks, hedge funds, insurers, and other sophisticated entities, are very eager and ready to begin trading on SEFs; other market participants will require more time to prepare themselves for SEF trading. The same is true with regard to the “readiness” of different products for SEF trading. The volume and liquidity of what are viewed as “plain vanilla” interest rate swaps, credit default and currency swaps make them prime candidates for early movement to SEF trading; but other products will take more time. The CFTC and SEC are currently engaged in the process of determining how to properly phase in participants and products as part of their effort to effectively sequence the implementation of the range of Dodd-Frank regulations and we believe the relative “readiness” of market

participants and products ought to play a significant role in that phasing/sequencing determination.

It is also worth noting however that if “readiness” is viewed in the context of capability to conduct the type of electronic trading envisioned for SEFs, Bloomberg in specific and the financial industry in general are very ready to commence SEF trading. The volume of electronic trading over the past decade has been enormous and the infrastructure to create the connectivity for SEF trading certainly exists. We have witnessed ever increasing migration of trading to a variety of electronic trading formats. Bloomberg itself has witnessed an accelerated use of our electronic platforms since the passage of Dodd-Frank a year ago. That said, SEF-style trading which entails multilateral trading and direct routing to clearinghouses remains rare since most current OTC swaps trading is bilateral and not submitted for clearing.

We further note that if “readiness” is viewed from the perspective of the state of the legal framework for the clearing and increased transparency imposed by Dodd-Frank for SEF trading, there is considerable work still ahead for the industry. Clearing and transparency are certainly priority objectives of Dodd-Frank’s SEF regime as means to mitigate systemic risk, but those rules have not yet been articulated in final form by the CFTC and SEC. We expect those rules, once promulgated in final form, will be novel in many ways and costly, and it will take time for market participants to do all the things necessary to accommodate those rules in terms of legal documentation, installation of technology, and other critical responses. With regard to documentation alone, there is a significant number of necessary items that will require time for negotiation between

interested parties and for careful drafting by lawyers.³ Ultimately, how much swaps trading moves to SEF platforms will be influenced by the complexity of the agencies' final rules and the cost of those rules for clearing, documentation, reporting and the like that must be borne by SEFs and their customers. The objective of those rules should be to minimize their cost and complexity in order to incentivize optimal movement of swaps trading to properly regulated SEF platforms and to minimize avoidance of those newly regulated SEF platforms.

Question 2: How do you expect the open access requirements for clearinghouses to impact the development of SEFs? Are there any obstacles to clearinghouses meeting this open and non-discriminatory access requirement?

Bloomberg has been successful in securing access to various clearinghouses for its existing OTC trading platforms. While mandatory swaps clearing as envisioned by Dodd-Frank is not completely worked out in all regards, we are cautiously optimistic that in a reasonable time we will have no significant problems with clearing for trades on our registered SEF platforms. We believe that our connectivity to a range of clearinghouses will provide end users a desirable choice in where to clear their swaps, which effectuates one of the objectives of Dodd-Frank which was to empower end users in that regard. It should be emphasized however that the cost and uncertainty of the rules on clearing swaps under the Dodd-Frank regime could be impediments to the proliferation of SEFs.

³ While not an exhaustive list, the large and complex range of documents that need to be negotiated and drafted include: derivative clearing organization agreements, swaps data repository agreements and protocols, platform participant agreements and end user agreements, independent service vendor agreements, and information sharing agreements with corresponding SEFs and Designated Contract Markets trading swaps to effectuate compliance relating to position limits and manipulation issues. In addition, SEFs will have to draft participant rulebooks, compliance manuals, connectivity agreements, anti-money laundering documentation, and numerous other vital documents.

Question 3: What regulatory and market-based incentives can facilitate the development and success of SEFs?

Bloomberg believes that the federal regulatory agencies should focus on creating well-articulated rules for clearing and post-trade market transparency, and to the maximum extent possible allow SEFs flexibility in fashioning their own trading protocols. In our judgment the most important incentive that can facilitate the development and success of SEFs is to give the SEFs significant latitude on the trading protocols they use. Maximizing the flexibility for SEFs to devise and implement their trading protocols will encourage innovation, competition and market responsiveness. In contrast, prescribing trading protocols by regulation will inhibit attainment of those public policy objectives and decrease overall SEF participation and market liquidity. It is noteworthy that the swaps market evolved to give swaps users highly customizable products that allowed them to meet specific investment objectives. Losing that tradition of flexibility to overly constrictive trading requirements would be destructive to the goal of encouraging a vibrant, competitive, and innovative SEF market.

Question 4: Do any barriers currently exist in the derivatives market that would inhibit the entrance of additional SEFs into the marketplace? Are there ways to mitigate those barriers, and how would those changes impact the derivatives market?

Given the technology afforded by the internet and connectivity, technological barriers to entry are relatively low. However, we do perceive several elements of the Dodd-Frank regime that could create barriers to entry in terms of increased risk and cost for entities considering registering as SEFs.

- **Micro-management and over-regulation of trading protocols:**

Central clearing ensures that there is sufficient capacity for the market to absorb losses within its own structure and trade reporting promotes price transparency which ensures price fairness. Both of these elements of Dodd Frank are beneficial to the market and ultimately to the individual investor and taxpayer. But trying to regulate with specificity the trading protocols may discourage the use of SEFs, and undermine the benefits that Dodd-Frank was designed to deliver through SEFs by reintroducing risk and removing liquidity. For example, mandating the use of a central limit order book would encourage the style of algorithmic and speculative trading that were at the center of the equities flash crash in 2010. Such an event would not be possible with today's fixed income trading structure.

Similarly, mandating the number of dealers that can participate in an RFQ may actually create liquidity risk because investors will only be able to trade if there are the mandated minimum number of market participants available. The proposed minimum requirement of having 5 respondent dealers for a SEF's RFQ platform reduces the end user's ability to achieve best execution because they will be forced to advertise their activities to a broader set of market participants than they may want. This problem is particularly acute with regard to block trades. The same can be said of imposing mandatory protocols that would require a block trade to interact with any resting interests on a SEF.

Liquidity providers responding to a block trade RFQ need to factor in the size of the trade when quoting a price. Imposing a trading protocol that could materially alter the size of a block trade would inject uncertainty for the liquidity provider responding to

an RFQ. Rather, liquidity providers should be given the option of interacting with resting bids (i.e. standing bids posted on platforms without reference to any particular RFQ) if it is consistent with their trading strategy and best execution, and SEFs should be allowed to offer that flexibility to the market.⁴ Similarly, liquidity seekers tend to vary their strategies as to the number of liquidity providers they include in an RFQ. Their strategies typically depend on the particular instrument (and its relative liquidity), the direction (long or short), and the size of the transaction they are seeking to execute. Liquidity seekers should have the flexibility in any given transaction to identify the optimal number of liquidity providers from which to seek bids.

Nor should SEFs be limited to one model or methodology in disseminating composite indicative quotes to the market. Developing a meaningful composite is a complex process involving intricate proprietary algorithms and each SEF has a compelling reason to develop a composite indicative quote that represents the most accurate reflection of the markets that meets participant needs and expectations for accuracy. A SEF that offers a composite that is consistently “away” from the actual market will quickly be disciplined and marginalized by participants’ disuse of that SEF.

There are other examples of the wisdom and value of allowing SEFs flexibility at the trading protocol level but the above illustrations convey the point that overly prescriptive mandates in this area are both unnecessary to the desirable functioning of SEFs and will effectively create barriers to SEFs coming into the market.

⁴ So too, forcing a minimum number of dealers into the RFQ process will likely increase cost with no compensating offset or benefit. We observe that the SEC’s proposed SB-SEF rules do not mandate transmission of an RFQ to a minimum or maximum number of liquidity providers.

- **Cost of Compliance:**

The greatest current cost of compliance lies in the different rules promulgated by the CFTC and SEC. While Dodd-Frank requires these two agencies to coordinate their approach, it remains to be seen whether they will sufficiently do so in their respective final regulations. If they fail to do so, the result will be that to operate as both a SEF and a SB-SEF an entity will be compelled to create two separate companies to trade what in essence are the same type instruments. This not only affects each potential SEF and SB-SEF but also their clients, many of whom use the same individual traders to trade both instruments types. The effective doubling of costs due to the inability of the two regulatory bodies to sufficiently coordinate their rules would not only be regrettable but creates a barrier to entry for the independent firms wishing to become SEFs and SB-SEFs. It is fair to ask whether that may only auger concentration in the SEF space and a "too big to fail" situation for the remaining SEF's in the marketplace, which is exactly the opposite of what Congress intended when they included the idea of SEFs in Dodd-Frank.

The creation of a complex set of overly detailed rules to manage trading protocols within the SEF market will generate significant regulatory compliance costs for SEFs which will have to be borne ultimately by the end users of the SEF platforms. Such costs can be mitigated by allowing the SEFs maximum flexibility to create their own trading protocols.

Costs can further be reduced by providing a robust opportunity for SEFs to contract with third party service providers for such things as market surveillance, trade practice surveillance, real-time market monitoring, investigations of possible rule violations and disciplinary actions. In contracting for such services—while maintaining

Dodd-Frank's requirement that SEFs retain full, ultimate responsibility for decision making involving those functions—SEFs can avoid the capital and operational costs of creating the infrastructure of those functions for themselves internally and thereby reduce both the cost of entry into the SEF market and the cost of ongoing SEF operations.

Beyond being allowed to use the expertise of third party service providers, SEFs also should be permitted to rely on the regulation and oversight of market participants and swap products by swaps clearinghouses rather than have to replicate essentially the same activity at the SEF level. For example, if a clearinghouse accepts a market participant for clearing purposes or accepts a swap for clearing, the SEF should be permitted to rely on that assessment for Core Principle compliance purposes regarding its obligation to establish that the market participant is an eligible swap participant or that the swap is not susceptible of manipulation under the SEF regulatory regime.

- **Governance constrictions:**

Dodd-Frank requires the agencies to minimize opportunity for conflicts of interest in the governance of SEFs which would allow anti-competitive behavior injurious to other market participants. Both the CFTC and SEC have proposed regimes for mitigating conflicts of interests through ownership limitations and structural governance requirements. These rules were written to address risks arising from a situation where a SEF would be owned and controlled by other market participants who would be tempted to set SEF policy to advance their own interests and to the detriment of other market participants and the market in general.

Requiring all SEFs to meet these ownership and governance constrictions is a serious and unnecessary barrier to entry in the case of SEFs whose ownership structure

does not present the risks that Dodd-Frank's conflict of interest provisions were intended to prevent.⁵ Bloomberg is an independently owned entity, meaning that other market participants do not have an ownership interest in the company. We are not beholden to either buy side or sell side interests. There is no public policy purpose in requiring Bloomberg or any other an independently owned firm to jump through unnecessary hoops and contort its governance to prescribed forms designed to prevent conflicts of interest risks that demonstrably do not exist due to their independent ownership structure and business model. We believe that where a SEF is not owned by its customer-members or other market participants and where the SEF can demonstrate a sufficient mitigation of legitimate potential conflicts of interests the agencies should permit that SEF an exemption from the governance restrictions which were designed to redress conflicts arising from cases where market participants own and control the SEF. Such an exemption would mitigate prospects that the governance rules would serve as an unproductive barrier to entry for independently-owned SEFs who can bring to the market the competition that Dodd-Frank sought to generate in swaps trading.

- **Extraterritoriality and International Harmonization:**

The swaps marketplace is a global business. A large percentage of transactions on Bloomberg's swap platforms involve non-US banks and other foreign institutions. An entity seeking to register as a SEF desires to have consistent standards applicable to both SEFs and market participants across different jurisdictions. Without such coordination a SEF may be put in the untenable position of enforcing rules against certain participants

⁵ While SEC has suggested they may require universal compliance with these conflict/governance rules even for independent entities, that view is not required by Dodd-Frank, nor is that interpretation a requirement written into the CFTC's proposed rules. Beside being irrational because independent entities do not present the governance conflict risks the rules were designed to address, applying those rules would add unnecessary cost to independent entities operations without any countervailing public policy benefit.

that are inconsistent, or worse, conflicting with foreign rules. Moreover, without harmonized and consistent standards a SEF could be required to have one set of rules for US participants and another set of rules for non-US participants, with a further set of transaction-level rules based on the counterparties or underlying instruments. The resulting legal uncertainty associated with an uneven playing field and regulatory arbitrage can be a significant disincentive to becoming a SEF, to maximizing a SEF's availability to market participants, or to the scope of the products offered for trading on the SEF.

Question 5: How do you expect the SEF marketplace to develop over time? How many SEFs would you imagine operating in the United States and around the world 5, 10, and 20 years after full implementation of the derivatives title?

The existence of multiple SEFs will at least initially be a function of asset classes (credit, interest rates, currencies, commodities, equities) and market function (liquidity seekers versus liquidity providers). Initially, one can fairly assume that there may well be a larger number of SEFs in each asset class and market function, which over time may yield to consolidation based on the gravitation of the pool of liquidity to certain SEFs based on their superior performance and their more favorable system functionality.

Having said that, predicting the number of SEFs globally is complicated by the fact that outside the US there are no specific regimes to regulate swaps as SEFs are envisioned by Dodd-Frank. It can be said that in terms of US-registered SEFs, the number of SEFs will be inversely proportional to the number and strength of barriers to entry. In this regard, the problem we foresee with unnecessary and unwise limitations on the flexibility of SEFs to determine their own trading protocols will be paramount. To

the extent that SEFs are homogenous, required to fit a specific “one size fits all” regime on trading protocols, they will increasingly resemble cookie cutter utilities, providing less innovation and responsiveness to market participants’ evolving needs for those SEFs in the market and less incentive for new SEFs to enter the market to compete with incumbent SEFs. But the more flexible SEFs can be with their trading protocols the more incentive there will be for all SEFs to distinguish themselves with innovation, vigorous competition and increasingly more cost effective functionality for the market—all of which enhances the incentive for SEFs to come into the market in greater numbers.

Question 6: What policy considerations, if any, should Congress or the regulators consider in order to better support the successful development of SEFs?

The key public policy element we would suggest to Congress and the federal regulators to better support successful development of SEFs relates to flexibility of trading protocols. There is little disagreement that clearing and transparency are good for the market and will reduce systemic risk created by large concentrations of derivative positions. However, overly prescriptive methods of execution threaten market liquidity and create risks of unintended adverse consequences such as incentivizing trading that avoids SEFs (dark pools) and flight to less regulated foreign markets. Enabling SEFs to rely on aspects of the DCO compliance regime that would otherwise replicate compliance obligations imposed on SEFs would reduce SEF costs and incentivize SEFs to focus productively on their trading protocols which will maximize innovation, competition and market responsiveness.

Conclusion:

SEFs represent a very valuable opportunity to achieve the reduction of systemic risk and transparency objectives of Dodd-Frank. Overly constrictive swaps trading rules will seriously diminish the contribution that SEFs can make to achieving those laudable public policy objectives. It is imperative, especially at the outset of the Dodd-Frank regime, that the regulations pertaining to SEFs do not mitigate the promise SEFs represent to achieve those legislative objectives which will keep the US markets at the vanguard of international finance. In our view, this means the federal regulators should not approach regulation of trade execution protocols from the same conceptual perspective as may be required for clearing and post-trade transparency. SEFs need operational flexibility at the trade execution level and without it one should not expect a robust emergence of SEFs or the ongoing innovation, competition and customer responsiveness they can bring to the market.

On behalf of Bloomberg I want to extend my appreciation for having this opportunity to appear before the Subcommittee to express our views. We are happy to be of further assistance to you as you continue your deliberations on these extremely important issues.