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Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for inviting me today to discuss progress and concerns surrounding the creation of swap execution facilities.

I'm Kevin McPartland, a Principal and the Director of Fixed Income Research at TABB Group. TABB Group is a strategic research and advisory firm focused exclusively on the institutional capital markets. Our clients span the entire investment landscape including investment banks, pension plans, mutual funds, hedge funds, high frequency traders, FCMs, exchanges and clearinghouses. We also operate TabbFORUM.com, a peer-to-peer community site where top level industry executives share thought leadership on important issues affecting the global capital markets.

In order for this new market structure to be successful, swap execution facilities must be given broad latitude in defining and implementing their business models – this includes, but is not limited to, the mechanisms used for trading and the risk profiles of their members. This will promote the innovation and competition that has made the US capital markets the envy of the world.

It is also critical that the mechanisms to move trades quickly and easily from execution to clearing are well defined. If market participants worry that the trade they have just executed on a SEF might later in the day be canceled due to a clearinghouse rejection,

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confidence in the entire market model will erode quickly, and severely limiting the transparency and systemic risk reduction Dodd-Frank was intended to improve.

New Market Structure

Despite these open concerns, industry sentiment toward the creation of swap execution facilities has turned positive. Based on a TABB Group poll published in April 2011, of more than 140 market participants, 87 percent believe the creation of swap execution facilities will ultimately be good for the swaps market. Of course, everyone defines "good" differently – good for liquidity, for transparency, for profits. Regardless, this demonstrates how the market's view that nearly every business model can – and most will – be adapted to work under the proposed SEF rules.

That being said, no solution will satisfy all market participants – nor should it. Regulators should not try to appease everyone in the market but instead focus their efforts on creating a set of rules that work.

To finalize the new swaps-market rules, regulators can either attempt to fit these products into old structures (such as a futures structure), or develop new mechanisms to manage these products. TABB Group believes regulators should look toward the new rather than wrap a new product in an old package. To that end, we are all presented with the rare opportunity to build up this market from scratch in such a way that it will function effectively for farmers who need to hedge crop prices and global financial institutions working to keep the world's economy flowing.

The exchange model was created over two hundred years ago long before electronic trading and high-speed market data. Today we're creating a new 21st-century market, but why would a paradigm from the 1800s make sense as a starting point? With little legacy legislation, rules can be written based on what we know now, not based on the structures developed in 1934 via the Securities and Exchange Act.

Trading Style and Membership Requirements

In order to develop the most suitable market structure for swaps, we must provide swap execution facilities with the freedom to utilize trading styles and different business models, ensuring every market participant has the most efficient access to liquidity possible.

Firstly, SEFs should not be driven to a particular trading model. Despite the inclusion of the Request for Quote model in proposals from the CFTC and SEC, regulators are keen to have swaps trade through an order book with continuous two-sided quotes.

TABB Group research shows that order-book trading will emerge naturally - 81% believe we will have continuous order book trading of vanilla interest rate swaps within two years of SEF rule implementation. However, the existence of an electronic order book does not guarantee liquidity nor that market participants will trade there.

For example, of the roughly 300,000 contracts available for trading in the electronic US equity options market, only 100 of those make up about 70% of the volume. The rest are seen as so illiquid that it is often easier to trade OTC with a broker rather than try and execute that same contract on the screen. Furthermore, despite the market's electronic nature, TABB Group research shows that in 2010 as much as 97% of all options trading volume generated by asset managers was done over the phone.

Second, we should encourage SEFs to set membership requirements to encourage a variety of liquidity pools. The US equity market presents a good example. Thirteen registered exchanges and another 55 alternative execution venues exist to trade US equities for a total of 68. Why? Because different market participants trade in different ways and have different needs. Some like to trade in large size, some small; some are very concerned about price while others are more concerned about getting a trade done quickly. Because of this, the equity market responded with new venues to meet those needs.

Although the equities market is very retail focused and the swaps market is purely institutional, a similar dynamic exists. The trading style and needs of a mutual fund are very different from those of a major dealer or a hedge fund. We therefore should encourage swap execution facilities to develop business models that help all market participants, and allow SEFs to compete with each other for whichever client base they chose to serve. This means allowing SEFs to not only define the method of trading, but requirements for entry.

For example, if you were willing to pay the membership fee, a restaurant supply store would be willing to sell you food for your family in the same bulk sizes they provide for restaurants. But since most American families do not need to buy food in bulk, we choose instead to shop at a local supermarket. The price per unit might be higher, but it is a more suitable way to shop for a family of four. Although the analogy might appear flippant, it explains why loosely defined tiers must still exist for trading swaps.

In the current market, a smaller player cannot trade in the inter-dealer market even if they had the capital and desire. In the new market, as long as a trading firm meets the requirements set forth by the SEF, they will be – and should be – allowed in to trade. The important point to note is that setting membership requirements for SEFs is not exclusionary, but instead intended help market participants trade in the most suitable environment possible.

Clearing

Open access to clearing will play a huge role in the success or failure of all SEFs. It is central clearing, not the SEF construct itself, that will allow easier access to trading and new market participants to enter. But a clearinghouse providing only the ability to accept SEF executed trades is not enough.

SEFs are intent on providing click-to-trade functionality, that when you accept a price on the screen with a click of the mouse, whether in an order book or via a request for quote, the trade is done. However, a trade is not done until it is accepted for clearing – something the SEFs have little if any control over. That raises the question: can a SEF ensure a trade will be accepted for clearing before it allows the trade to execute? And even if it can, is that its responsibility?

Either way, clearing certainty is crucial to the success of SEFs. If market participants worry that the trade they have just executed on a SEF might later in the day be canceled due to a clearinghouse rejection, confidence in the entire market model will erode quickly and limit severely the transparency and systemic risk reduction Dodd-Frank was intended to improve. It is critical that a mechanism be put in place to formalize this process, ensuring the market can have full faith in the trades they execute on a SEF.

Size of the Market and Open Issues

There has been considerable speculation as to the number of SEFs that will exist. The wildest number I've heard is 100 which is simply unrealistic. If the US equities market has 68 venues and the US futures market has 3 main players, the swaps market will fall somewhere in the middle.

Our research shows also that nearly 60% of market participants believe the ideal number of SEFs per asset class is three to four, resulting in 15 to 20 SEFs covering interest rates, credit, FX, commodities and equities. There will be many more than that to start but not 100 – our list at TABB Group shows as many as 40 firms that plan to apply – but 87% of our study participants believe that SEF consolidation will begin two years or less from the date of rule implementation.

Timing

Rule-writing delays at the CFTC and SEC are unfortunate but necessary. The financial services industry is ready to move ahead to the next chapter, but it is more important that these rules are written properly rather than in haste. Despite the fact that so much uncertainty remains, the industry is moving ahead with preparations for SEF trading, central clearing, trade reporting and the myriad of other new requirements.

We are now in the pre-SEF era. Business models and technology are being finalized, but most SEFs are "registration-ready" and trade flow is beginning to pick up on the screen as most everyone has accepted that these changes are inevitable. Tradeweb, a trading platform set to register as a SEF, tells us their trading volume is up 47% from last year. We see this level of growth happening with several of the existing platforms. Even if trading mandates don't take effect until the fourth quarter of 2012 – a timeframe that seems more realistic – the change is so enormous for most swaps traders that getting started now should present just enough time to make the switch.

Winners and losers, however, will not be chosen until after regulatory mandates are in place. Too many market participants still exist and see little economic incentive to shift, in addition to those new market participants waiting in the wings. But even still, working together, regulators and the industry have made significant progress during the past year, clarifying the view of what the post-Dodd Frank world of swaps trading will look like.

As rules are finalized, it is critical that while putting in place necessary oversight, new OTC derivatives rules encourage the innovation and competition that have made the US capital markets the most envied in the world.

Thank you.