Oral Statement of William Thum
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Emergence of Swap Execution Facilities: A Progress Report
Before the U.S. Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment

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Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for having me here today. My name is William Thum and I am a Principal and Senior Derivatives Counsel at Vanguard.

Headquartered in Valley Forge, Pennsylvania, Vanguard is one of the world's largest mutual fund firms. We offer more than 170 U.S. mutual funds with combined assets of approximately $1.7 trillion. We serve nearly 10 million shareholders including American retirees, workers, families and businesses whose objectives include saving for retirement, for children's education or for a down payment on a house or a car.

Vanguard's mutual funds are subject to a comprehensive regulatory regime and are regulated under four federal securities laws. As a part of the prudent management of our mutual funds, we enter into swaps to achieve a number of benefits for our shareholders including hedging portfolio risk, lowering transaction costs, and achieving more favorable execution compared to traditional investments.

Vanguard has been supportive of the Dodd-Frank Act's mandate to bring regulation to the derivatives markets to identify and mitigate potential sources of systemic risk.

Vanguard supports a phased implementation schedule over an eighteen to twenty-four month period following rule finalization based on the following objectives:

- prioritizing risk reduction over changes to trading practices and market transparency;

- prioritizing data reporting to inform future rulemaking related to trading practices and market transparency (to minimize a negative impact on liquidity);

- harmonizing overlapping U.S. and global regulatory efforts; and

- allowing immediate voluntary access for all party types to the new platforms with mandated compliance to apply initially to swap dealers and major swap participants.

In view of the time needed to digest the final rules and develop industry infrastructure; to implement complex operational connections required for reporting, clearing and exchange trading; to educate clients on the changes and obtain their consent to trade in the new paradigm; and to negotiate new trading agreements across all trading relationships, Vanguard supports the following implementation schedule:

- 6 months from final rules: Swap Data Repositories, Derivatives Clearing Organizations, SEFs and middleware providers must complete the build-out of their respective infrastructures.

- 6 to 12 months from final rules: All participants should voluntarily engage in reporting, clearing and trading platforms.

- 12 months from final rules: All participants should be mandated to report all swaps involving all parties. Dealers and major swap participants should be mandated to clear the first list of “standardized swaps”.

- 18 months from final rules: All participants should be mandated to clear the first list of “standardized swaps”. SEFs and Commissions can analyze SDR swap data for liquidity across trade types to make informed SEF trading mandates, block trade size and reporting delays. Dealers and major swap participants should be mandated to trade the first list of “standardized swaps” “made available for trading” on SEFs.

- 2 years from final rules: All participants should be mandated to trade the first list of “standardized swaps” “made available for trading” on SEFs with delayed public reporting of block trades based on historical relative liquidity.

The need for a phased implementation schedule is supported by recent studies which have identified significant differences in liquidity between the swaps and futures markets. While futures trading is characterized by high volumes of a limited range of trade types of small sizes and limited duration, the swaps market has an almost unlimited range of trade types of much larger sizes with a much longer duration. Swaps liquidity varies dramatically with high liquidity for two-year U.S. dollar interest rate swaps, and much smaller liquidity in credit default swaps on emerging market corporate entities.

The potential negative consequences related to liquidity are best demonstrated by the impact of the premature public reporting of large-sized block trades. When quoting a price for a block trade, dealers typically charge a slight premium to the then current market price for a similar trade of a more liquid size. Once the block trade is executed, the Swap Dealer executes one or more liquid-sized mirror trades at current market prices to lay-off its position and to flatten its market exposure.

The premature public dissemination of block trade details will provide the market with advance knowledge of the dealer’s imminent trading and is therefore likely to move the market against the dealer. Fund investors will ultimately have to bear either the increased price of relevant trades, or the increased costs of establishing positions using multiple trades of liquid sizes.

The CFTC's proposed test for block trade size, and the CFTC and SEC's proposed time delay for the public dissemination of block trade data are too conservative and are likely to have a serious negative impact on liquidity. Particularly as such proposals address market transparency and not market risk, the more prudent approach would be to make informed decisions based on a thorough analysis of market data with larger block trade sizes and more prompt public reporting for the most liquid products and smaller sizes and delayed reporting for less liquid products.

In addition to the need for SDRs, DCOs and SEFs to establish fully functional platforms, the central clearing of derivatives will require the negotiation (and possibly renegotiation) of all existing master trading agreements to establish the required clearing relationships for swaps. While ISDA and the Futures Industry Association are working on a standard form of addendum for cleared swaps to add to parties' futures agreements, as there is no market standard form of futures agreement, and existing futures agreements may not address a number of key business issues related to the clearing of swaps, the futures agreement itself is likely to require significant renegotiation.

Even if the larger market participants can promptly work through the process with dealers, many smaller participants could effectively be cut out of the swaps market altogether if the documentation process is not completed ahead of the clearing deadline.

There are a number of other significant issues related to the SEF trading mandates proposed by each of the CFTC and SEC which I am happy to discuss in the question and answer period. Such issues include the CFTC's proposed requirement for "Requests for Quotes" to be distributed to a minimum of 5 dealers, the CFTC's and SEC's mandate for participants to "take into account" or to "interact with" other resting bids and offers (including indicative bids and offers), the CFTC's requirement for there to be a "15 second delay" involving crossing trades, and the need for harmonization across the CFTC and SEC rulemaking to avoid unnecessary complexities.

Thank you for this opportunity to share our views with the Subcommittee and we will be pleased to serve as a resource for the members with respect to the swaps rulemaking exercise.