

Testimony of Donald P. Fewer
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Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
U.S House of Representatives

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Mr. Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee:

Good morning. My name is Donald P. Fewer, Senior Managing Director of Standard Credit Group, LLC, a registered broker/dealer and leading provider of execution and analytical services to the global over-the-counter interdealer market for credit cash and derivative products. I was fortunate enough to have consummated the first trades between dealers at the markets inception in 1996 and have participated in its growth and development as well as its challenges. I would like to thank the Subcommittee for the opportunity to share my thoughts on the regulation of the over-the-counter derivatives market.

Legislation that addresses derivatives markets accountability and transparency must reflect a clear understanding of market dynamics, particularly in the area of credit risk transfer. With this in mind, I would like to address five areas of interest before the Subcommittee:

- Regulation of the OTC Derivatives Market
- Mandated Central Counterparty Clearing of OTC Derivative Products
- Inherent Risks of Mandated Exchange Listing and Execution of OTC Derivative Products
- Price Discovery and Pre-trade/Post-trade Transparency
- Data Warehousing and the Maintenance of Books and Records
- Electronic Execution

Regulation of the OTC Derivatives Market

Virtually every post mortem and reverse engineering analysis of the credit crisis points to the need for enhanced regulation of the OTC markets. Results from such analysis point to multiple and sometimes conflicting causes of the crisis and the role played by the OTC derivatives market and CDS specifically. Notwithstanding these differences of opinion, a revamped, more cohesive regulatory regime is the mantra of the day and we generally support these efforts. Specifically, the establishment of a systemic risk regulator with the authority and accountability to regulate financial institutions that are determined to be systemically important is warranted. Standard Credit is in favor of enhanced regulation that works to achieve this end. Such regulation need not try to reshape the market or alter its underlying functionality. New regulation should observe that the U.S. share of global financial markets is rapidly falling and oversight consolidation should not be attained at the expense of U.S. competitiveness. Legislation that creates a regulatory environment that prohibits capital market formation will push market innovation and development to foreign markets. It is estimated that the inter-dealer broking industry in the United States generates \$4 billion in revenues. A substantial portion of this revenue stream, with its associated individual and corporate tax base, would migrate off U.S. soil. The data and technology exist to provide ongoing information to the designated regulatory authorities on market participants, their credit worthiness, daily exposure, leverage and risk profile without eliminating the risk incentive necessary for market makers to remain active in underlying activities. In short, don't strangle the markets but facilitate their growth and competitiveness through active, ongoing accountability.

Mandated Central Counterparty Clearing of OTC Derivative Products

Central clearing facilities of organized exchanges or other entities to be developed will not only work to eliminate counterparty credit issues in OTC bilateral derivative contracts, it will undergird and strengthen the OTC derivatives market infrastructure. Central clearing will serve to reduce systemic risk by providing multilateral netting and actively manage daily collateral requirements. There exists enough evidence in the major OTC derivatives asset classes (i.e., Interest- rate, Credit, FX, Energy and Equity) that mandated clearing of the most standardized and liquid product segments is congruent with efficient global derivative product trade flow. I would caution that the standardization requirement be properly evaluated so that the constitution of a "standardized" product and a "bespoke" product be clearly delineated. This will impact issues such as the economics of initial and maintenance margin requirements for derivative products which will determine the viability of the clearing process. The

difficulties clearing Single-name Credit Default Swaps (CDS) is an example of this. With specific regard to CDS, centralized clearing can be the mechanism by which new capital and liquidity providers participate in the credit risk transfer market. The use of CCPs by all market participants, including “end users” (i.e., hedge funds, asset managers, private equity groups, insurance companies, etc.) should be encouraged by providing open and fair access to key infrastructure components including but not limited to central clearing facilities, private broker trading venues and derivative contract repositories. OTC trading venues can provide voice and electronic pre-trade transparency, trade execution and post-trade automation. This view of providing access to all market participants, sell side and buy side, to an open platform centered in CCP, will stimulate credit market liquidity by re-connecting more channels of capital to the credit intermediation and distribution function.

However, I would caution against the expansion of the role of organized exchanges beyond CCP to include mandated exchange execution of OTC derivative products.

Mandated Exchange Listing and Execution of OTC Derivative Products: Disruptive and Unnecessary

There has been a lot written and said about mandatory listing of OTC products on exchanges. Given the size and establishment of the OTC derivatives market, migration toward exchange execution has been and will be minimal apart from mandatory legislative action. It seems logical that if the structure of the OTC market lent itself easily to exchange traded products that the exchanges would have stepped in a long time ago to capture that part of the market. It is now being argued that the lack of standard product specifications of OTC derivatives is a market flaw and should be remedied by mandated exchange listing and execution. This argument is inaccurate. OTC derivatives markets use well recognized standards of size, price, payments and maturity dates. Because of these recognized standards, OTC dealers globally are able to efficiently customize and execute trillions of dollars of customer orders within generally acceptable terms to the market. The OTC USD interest rate swap market is an example where mandatory exchange execution would disrupt the efficiency of the breadth and depth of global market liquidity. A US bank dealer working on a multi-national corporate customer’s need to swap out of floating Euro and Japanese Yen rates on recently issued long term debt into fixed USD rates in large size in 10 and 20 and 30 yr maturities is not easily facilitated by an exchange. In this scenario, the loss of anonymity due to exchange post-trade reporting requirements could prove harmful to the end user.

The wholesale, institutional nature of global OTC derivatives markets yields little retail commercial application in an exchange environment. Retail product demand provides organized exchanges fair amounts of liquidity and trade flow. The absence of retail appetite for institutional product limits the potential liquidity sources for exchange listed derivative product. I think one should question the appropriateness of certain derivative products for a retail customer base even if demand existed.

There is a class of OTC product that is extremely conducive to exchange execution and can warrant exchange listing. Such products are well standardized with high degrees of trading frequency. Examples of such products include CDX IG Indices, Short-dated IMM swaps, etc.

In summary, although it has been argued that the “opaqueness” of the OTC derivatives market is a detriment to market transparency and price discovery and exchange listing and execution is required to increase the integrity and fairness of the market place, this position does not reflect current market realities. The type of post-trade transparency offered by an exchange will militate against risk taking and siphon off liquidity.

Price Discovery and Pre-Trade/Post-Trade Transparency

The over-the-counter market has a well established system of price discovery and pre-trade market transparency that includes markets such as US Treasuries, US Repo, EM sovereign debt, etc. OTC markets have been enhanced by higher utilization of electronic platform execution. Private broker platforms will interface directly to CCPs and provide automated post-trade services. This was clearly demonstrated in the wake of Enron’s collapse and the utilization of CCP facilities by the leading over-the-counter energy derivatives brokers to facilitate trading and liquidity. It is clear to all market participants that financial dislocation and illiquidity will persist across many asset classes and geographies for some time. As alluded to earlier, the unique nature of the OTC market’s price discovery process is absolutely essential to the development of orderly trade flow and liquidity, particularly in fixed income credit markets. We are entering a period with an abundance of mispriced securities where professional market information and execution is required. OTC price discovery will require a more focused and integrated execution capability between OTC derivatives and underlying cash markets. This type of exhaustive price discovery service can only be realized in the over-the-counter market via execution platforms that integrate derivatives and cash markets across asset classes (i.e., debt, equities, emerging markets, etc.). This will be critical to the repair of credit market liquidity globally.

Data Warehousing and the Maintenance of Books and Records

Enhanced post-trade transparency for all OTC derivatives transactions can be properly serviced by CCPs and central trade repositories that aggregate trading volumes and positions as well as specific counterparty information. These institutions can be structured to maintain books and records and provide access to regulatory authorities on trade-specific data. The public dissemination of aggregate market data can work to strengthen public confidence in the OTC markets generally.

I would not endorse OTC trade reporting to a level that is currently disclosed by the TRACE (Trade Reporting and Compliance Engine) system. Goldman Sachs recently reported that the value of cash bond trading has fallen each year over year for the past five years. The value of cash bond trading stood at \$12,151bn in 2003 and declined to \$8,097bn in 2008. There is ample evidence in the secondary OTC corporate bond market that the TRACE system caused dealers to be less inclined to hold inventory and commit capital to support secondary market liquidity. I would suggest to the Committee that fair and equitable trade reporting can be accomplished by nominating CCPs and trade repository/data “warehouses” to provide aggregated post-trade data.

Electronic Execution

OTC markets have been enhanced by the higher utilization of electronic execution. Successful utilization of electronic trade execution platforms is evident in markets such as US Government bonds, US Government bond repo, some European CDS markets. I would caution against mandated electronic execution of OTC cash and derivative products by regulatory action. Effective implementation of such platforms should be the result of a clear demand made by market makers and a demonstrable willingness by dealers to provide liquidity electronically. Our experience in North America is that the dealer community has refrained from electronic execution due to the risk of being held to prices during volatile market conditions. I think recent analysis shows electronic execution throughout the major asset classes has declined by approximately 25% year on year to date. I would strongly endorse the “hybrid” use of electronic platforms where market participants utilize the services of a voice broker in conjunction with screen trading technology.

Mr. Chairman, Mr. Ranking Member and Members of the Subcommittee, I appreciate the opportunity to provide this testimony today. I am pleased to respond to any questions you may have. Thank you.

