MEMO# 25319

July 8, 2011

ICI Statement for the Record on Development of Swap Execution Facilities

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 51-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 26-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 28-11
ETF ADVISORY COMMITTEE No. 45-11
EQUITY MARKETS ADVISORY COMMITTEE No. 42-11
SEC RULES MEMBERS No. 82-11
SMALL FUNDS MEMBERS No. 49-11 RE: ICI STATEMENT FOR THE RECORD ON DEVELOPMENT OF SWAP EXECUTION FACILITIES

ICI recently submitted a written "statement for the record" to the Senate Banking Subcommittee on Securities, Insurance and Investment in connection with a June 29 hearing held by the Subcommittee entitled, "Emergence of Swap Execution Facilities: A Progress Report." ICI's statement focused on the development of swap [1] execution facilities ("SEFs") by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") pursuant to Title VII [2] of the Dodd-Frank Act. [3] In addition to the ICI statement, a representative from Vanguard testified at the hearing, further representing mutual fund investor concerns regarding the developing regulatory framework for SEFs. [4] ICI's and Vanguard's statements are briefly summarized below.

ICI Statement

ICI's statement commented on several aspects of SEFs including investor representation in the governance structure of SEFs, providing flexible trading options on SEFs, and reporting of swap transaction data and the identification of block trades by SEFs. With respect to investor representation, the statement emphasized the importance of including investor representatives on the SEFs' boards of directors as well as board advisory committees. The statement explained that investor representation would help to minimize conflicts of interest by better balancing the advancement of commercial interests with the fulfillment of self-regulatory responsibilities. In turn, controlling conflicts of interest should reduce systemic risk in the swap markets. The statement also suggested that investor representation on SEF boards and board advisory committees 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 swap markets.

ICI's statement also addressed the need to provide a flexible execution framework when trading on SEFs. It focused on the importance of balancing transparency in the swap markets with the necessary flexibility to encourage the use of SEFs. Specifically, the statement commented on 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 statement explained that the CFTC's proposal to require that a RFQ be sent to five or more dealers would expose a fund to information leakage and "signaling" regarding the potential transactions, resulting in higher costs to funds and their shareholders. It also explained that the proposed requirement by the SEC for market participants to interact with resting bids and offers could hinder a fund's execution strategies and objectives as well as force a fund to break up its orders, resulting in higher transaction, reporting and margin costs. In addition, ICI's statement called for consistency between SEC and CFTC SEF trading restrictions to help minimize operational difficulties, control for costs and ensure that the rules accommodate flexible execution requirements that encourage trading on SEFs.

The statement raised concerns with the SEC and CFTC proposals related to block trades and reporting of swap transaction data. It stated that it is critical for the SEC and CFTC to identify the appropriate thresholds for block trades to avoid significant disruption to and negative implications for the swap markets, participants and customers. In particular, the thresholds must recognize the liquidity for each unique category of swaps and allow for flexible and anonymous block trading. ICI's statement also suggested that the SEC proposal conform to the CFTC proposal by allowing a transaction executed on a SEF to be reported by that SEF, absent an agreement by the swap counterparties to pursue an alternative reporting process. In addition, the statement suggested that the SEC and CFTC better harmonize and coordinate their proposals for reporting swap transaction data.

Vanguard Oral Statement

Vanguard's oral statement focused primarily on the importance of a phased implementation schedule for the swaps rulemaking. Setting forth several objectives for successful implementation of the new regulatory framework, the oral statement suggested that a realistic time period for implementation would be an eighteen to twenty-four month period following rule finalization. The oral statement offered the following 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, the CFTC and the SEC 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; and
- 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.

Tied into the discussion on implementation, the oral statement also commented on the importance of properly identifying block trade sizes and delaying the dissemination of transaction data for such trades.

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Attachment

endnotes

[1] Throughout this memorandum, the term “swap” will refer to both swaps and security-based swaps.

[2] Title VII is the provision of the Dodd-Frank Act that addresses regulation of the over-the-counter derivatives markets.

[3] 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, July 29, 2011 (“statement”).

[4] Oral Statement of William Thum, Principal and Senior Derivatives Counsel, Vanguard, 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, July 29, 2011 (“oral statement”).