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CFTC Chair Giancarlo Releases White Paper on Swaps Regulation Reform

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International/Global RE: CFTC Chair Giancarlo Releases White Paper on Swaps Regulation Reform

US Commodity Futures Trading Commission Chairman J. Christopher Giancarlo and Chief Economist Bruce Tuckman recently released a white paper assessing the agency's implementation of swaps reform and, in some cases, recommending improvements to the regime.[1] The white paper analyzes the Commission's data and experiences with swaps regulatory reforms in five key areas:

1. Swaps Central Counterparties: The white paper notes that swaps clearing is probably the most far-reaching and consequential reform adopted under Title VII of the Dodd-Frank Act. It notes that approximately 85 percent of new interest rate swaps and credit default swaps are now cleared. Notwithstanding the success of the swaps clearing mandate, the white paper raises three current challenges to swaps clearing: (i) ensuring central counterparties are safe and sound under extreme but plausible conditions; (ii) ensuring that central counterparty recovery plans comprehensively allocate losses, restore their matched books and replenish financial resources without government assistance; and (iii) planning for government-supervised resolutions of central counterparties in the event that recovery plans are inadequate.

2. Swaps Reporting Rules: The white paper states that visibility into the counterparty credit risk of major financial institutions was the most pressing issue during the financial crisis, and the regulatory failure to complete these rules was most disappointing. The white paper contends that the CFTC's largely principles-based approach to swaps data reporting has created an imperfect reporting regime because the CFTC did not provide sufficient technical specification illustrating the exact information to be reported. It then details ongoing efforts the CFTC is making toward standardizing swaps data reporting globally and makes several recommendations for improvement. Among these recommendations:

- The white paper acknowledges that post-trade transparency requirements should not be unvaryingly immediate as to make it difficult to trade large positions for fear of being "picked off" by a competitor. It recommends that the CFTC continue to work with market participants to determine appropriate transaction size thresholds and

lengths of delay for such reporting.
- The white paper recommends that the CFTC update requirements for swap data repositories (“SDRs”) and swap counterparties to verify the accuracy and completeness of data reported, which could be accomplished through SDRs providing regular reports to relevant reporting counterparties that review and verify whether the data is accurate.
- The white paper recommends a pilot program to study how modifications to the CFTC’s rules on public dissemination of swaps data could enhance block trading. The white paper calls for the pilot to study the effects of varying notional caps on public dissemination, block sizes and time delays potentially across different swap execution facilities (“SEFs”), asset classes and/or specific products for block trades.

The white paper also discusses the future for swaps data reporting using new technologies, such as distributed ledger technology that could improve the process greatly. It generally recommends that the CFTC look to collaborate with market participants on recalibrating the trade data reporting regime, so it is specific, accurate and useful enough to: (i) capture systemic risk in addition to market abuse and manipulation; (ii) harmonize with globally accepted risk data fields; and (iii) achieve transparency while promoting healthy trading liquidity.

3. Swaps Execution Rules: The white paper identifies the flaws in the implementation of the SEF rules that it believes have caused fragmentation of swaps trading, increased market liquidity risk, hindered swaps market technological innovation, and incentivized a significant amount of price discovery and liquidity formation to take place off SEFs. Among these mistakes, it notes that the CFTC grafted into its SEF rules several practices from highly liquid futures markets that are antithetical to episodically liquid swaps trading. The white paper notes that the swaps trading on SEFs has been stunted in two ways: (i) by limiting the execution methods for swaps;[2] and (ii) by adopting an overly narrow definition of what it means for a swap to be “made available to trade.”[3] It makes several recommendations in this area, including removing the constraints on methods of execution and expanding the category of swaps subject to the Trade Execution Requirement to include all swaps that are subject to the Commission’s clearing mandate. It believes that these changes should promote the full range of price discovery, liquidity formation and trading of swaps on SEFs and would better facilitate market transparency.

4. Swap Dealer Capital: The white paper notes that swap dealers consist mainly of banks and subsidiaries of bank holding companies. With such a large banking influence, the white paper argues that components of the bank capital regime result in a bias against risk taken through swap markets. It recommends that banking regulators correct this bias in two ways: (i) continue to iterate, and most likely complicate, prescriptive, regulatory models of risk imposed on dealers; or (ii) ascertain how to rely more heavily but confidently on the internal risk models that banks and their swap dealer affiliates use.

5. End User Exception: The white paper evaluates the Dodd-Frank exemption for commercial end users from clearing standardized swaps and required margin on uncleared swaps. It asserts that smaller financial end users should be exempt from these clearing and margin requirements through a material swaps exposure threshold that is reworked and measured in units more meaningful than notional amounts. The white paper also argues that uncleared margin rules can and should achieve their objectives without being as prescriptive as they are under current law. In this regard, the white paper recommends revising margin calculations to compute market risk for a waiting period appropriate for the portfolio rather than a set ten-day margin period of risk.

Chair Giancarlo intends to implement certain of the ideas in the paper but has given no time frame for implementation.[4]

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endnotes

[1] *See* J. Christopher Giancarlo, Chairman, and Bruce Tuckman, Chief Economist, US Commodity Futures Trading Commission, *Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps* (April 26, 2018), *available at* https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf.

[2] The white paper notes that the CFTC's swap rules constrain swaps required to be traded on a SEF to two methods of execution: an order book (as defined in 17 CFR 37.3(a)(2)); or a request for a quote from three broker). The white paper states that these methods vary from the traditional market structure and practices of swap-trading platforms.

[3] Congress required that all swaps subject to the clearing requirement be executed on a SEF or a designated contract market ("DCM") unless no SEF or DCM makes the swap available to trade ("Trade Execution Requirement"). *See* Commodity Exchange Act Section 2(h)(8).

[4] *See* CFTC Press Release No. 7719-18, *CFTC Chairman Unveils Reg Reform 2.0 Agenda* (April 26, 2018), *available at* https://www.cftc.gov/PressRoom/PressReleases/7719-18?utm_source=govdelivery (". . . we need to take the time to get this right. We have an ambitious timetable, and we will get this done, but we will do this right. We will move forward in regular order and in good order . . .").