ALERT MEMORANDUM

CFTC Chairman Giancarlo Unveils Swaps Regulation Version 2.0

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On April 26, 2018, Chairman J. Christopher Giancarlo and Chief Economist Bruce Tuckman of the U.S. Commodity Futures Trading Commission ("**CFTC**") released a white paper entitled "Swap Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps" (the "**White Paper**").[1] The White Paper covers five topics:

(1) Regulation of swaps central counterparties: the White Paper analyzes key challenges in relation to central counterparty ("**CCP**") risk mitigation, recovery, and resolution, but does not make any recommendations for specific changes;

(2) Swap reporting: the White Paper provides more information regarding the changes to regulatory reporting requirements that were originally proposed in a CFTC staff "roadmap" published in July 2017 (the "**Reporting Roadmap**")[2] and suggests a pilot program to study the effects of changes to public reporting requirements;

(3) Swaps execution: the White Paper reiterates and clarifies recommendations made by then-Commissioner Giancarlo in a 2015 white paper (the "**2015 Paper**"),[3] including eliminating restrictions on how swap execution facilities ("**SEFs**") can execute transactions, adopting enhanced staff proficiency requirements and conduct standards,

[1] Available at: https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf.

[2] "Roadmap to Achieve High Quality Swaps Data" (July 10, 2017), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/dmo_swapdataplan071017.pdf.

[3] "Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank" (Jan. 29, 2015), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf.

and expanding mandatory trade execution requirements to include *all* swaps covered by the CFTC's mandatory clearing requirement;

(4) Swap dealer capital: the White Paper criticizes aspects of existing capital standards that are insufficiently risk-sensitive, but does not make any recommendations for specific changes; and

(5) End-user exceptions: the White Paper recommends expanding end-user exceptions and providing firms more flexibility to set their own initial margin requirements, but acknowledges the need for coordination with U.S. Prudential Regulators and, possibly, foreign regulators.

Two of these topics—trade execution and trade reporting—are widely expected to be covered by rule proposals later this year. But the prospect for reform in the other areas is less clear. Shortly after the White Paper's release, Chairman Giancarlo announced that he would not seek reappointment following his term's scheduled expiration next April, which means there will be relatively little time for major policy shifts or interagency coordination during his tenure. Also, the agency faces continuing resource constraints that force difficult choices on what issues to prioritize.

For these reasons, perhaps as notable as what the White Paper covers are what it does *not*, including: the CFTC's framework for regulating cross-border swaps activities; harmonization with the Securities and Exchange Commission ("**SEC**"); revisions to the swap dealer *de minimis* threshold; position limits; and the "Project KISS" initiative. Given previous statements by Chairman Giancarlo and the recommendations contained in the Treasury Department's October 2017 report on capital markets regulation (the "**Treasury Report**"),[4] it seems unlikely that these topics have fallen off of the CFTC's radar. For some of them, statements by other CFTC officials, such as remarks by Chief of Staff Mike Gill in February 2018[5] and Commissioner Brian Quintenz earlier this month,[6] provide indication of where the CFTC is likely to be headed. What is less clear is whether there will be sufficient resources and bandwidth to get there.

[4] "A Financial System That Creates Economic Opportunities: Capital Markets" (Oct. 6, 2017), available at: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[5] "Remarks of CFTC Chief of Staff Michael Gill at the National Press Club, CFTC Kiss Policy Forum" (Feb. 12, 2018), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagill2.

[6] "Remarks of Commissioner Brian Quintenz at FIA's 40th Annual Law and Compliance Conference" (May 2, 2018), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz12.

CCP REGULATION

The White Paper addresses three key areas of CCP regulation: (i) CCP risk mitigation resources; (ii) CCP recovery plans; and (iii) CCP resolution.

CCP Risk Mitigation Resources

The White Paper identifies the following respects in which CCPs might lack sufficient resources to mitigate the risks they face:

- Liquidity of Prefunded Resources. The White Paper highlights CCPs' credit risks to bank depositories (for cash deposits) and repurchase agreement counterparties. It also addresses the liquidity risks of CCPs' securities holdings. The White Paper acknowledges that a CCP designated as systemically important under Title VIII of the Dodd-Frank Act can mitigate these risks by placing cash deposits at Federal Reserve and, in unusual or exigent circumstances, obtaining collateralized loans from the Federal Reserve. But it goes on to express concerns that limiting these measures to designated CCPs might raise barriers to entry in the CCP industry and overly restrict what can be done to assist non-designated CCPs.[7]
- Correlated Defaults and Network Effects. The White Paper suggests increased attention to the risks of correlated defaults and associated network effects involving CCP members. Although it notes that CCP stress tests administered by the CFTC in 2016 showed that clearing members with significant losses at one CCP in a given stress scenario did not tend to have significant stress losses at other CCPs in that same scenario, the White Paper also noted that CCP members can have correlated exposures and linkages through their non-derivatives activities (such as prime brokerage balances and financing activities) that are not captured by these stress tests or other CFTC risk monitoring activities.
- Liquidation of Defaulted Swaps Positions. The White Paper suggests that there should be greater scrutiny of the margin charges for the costs of replacing defaulted positions with another counterparty in light of the difficulty in calculating those potential liquidation costs. The White Paper stresses that CCPs should consider their ability to quantify their liquidation costs under difficult market conditions before accepting new and less liquid products.
- Design of the Waterfall. The White Paper notes that CFTC regulations set a standard for the total quantity of a CCP's prefunded resources but do not dictate the relative contributions in the form of members' default fund contributions and CCP owners' default fund contributions ("skin in the game"). It states that the "issue here is whether incentives are aligned so as to achieve a socially optimal level of risk taking at a CCP."

Although the White Paper identifies the potential for misalignment of incentives in connection with the design of CCP

[7] Interestingly, the White Paper does not flag the potential risks to U.S. financial stability by lack of Federal Reserve deposit account access for non-U.S. CCPs with significant shares of U.S. clearing business, even though this issue was highlighted by the Treasury Report. *See* Treasury Report at 165.

waterfalls, it does not draw the connection between this issue and the other challenges it identifies. In particular, clearing members have in the past been concerned that, if CCP owners do not have sufficient skin in the game, then they may have incentives to increase income to the CCP through investing prefunded resources in riskier assets, adopting less stringent criteria for eligible margin assets, and lowering margin charges for liquidation costs. CCPs also might not be as attentive to members' views regarding whether more volatile products should be covered by separate default funds—an issue that was highlighted recently in connection with the launch of Bitcoin futures and has led the CFTC to reevaluate CCP governance around the clearing of new virtual currency products. Since these issues are not limited to virtual currency products, however, the CFTC might consider a broader review of whether to establish additional standards for CCP governance and/or skin in the game.

CCP Recovery Plans

CFTC regulations require that systemically important CCPs have recovery plans in place to handle crisis situations without needing to resort to government assistance. While substantial advancement has been made in the development of such recovery plans, the White Paper highlights certain remaining challenges:

- Transparency and Predictability. Consistent with industry comments submitted in connection with the CFTC's Project KISS initiative,[8] the White Paper suggests that recovery plans should be more transparent and predictable to the extent possible so that market participants can "measure, manage and control their own risks."
- Uncertainty Surrounding Assessments. The White Paper implies that consideration should be given as to whether assessments from clearing members should be replaced with additional prefunded resources to account for the uncertainty as to whether clearing members will perform their obligation to provide assessments in a time of crisis.
- Role of Regulators. The White Paper takes the view that, while regulators must ensure that credible recovery plans are in place, they should be reluctant to mediate the disparate interests of CCPs, swap dealers, and end users.

Although the White Paper cautions against regulators mediating the distributional consequences of CCP recovery plans, how losses are borne in connection with CCP recovery can affect systemic risk because some classes of market participants are more likely than others to be able to take actions (such as closing out open positions on the opposite side of the market from a defaulting clearing member) that can help the CCP re-establish a matched book and otherwise dampen potential systemic losses. Also, some market participants are more likely

[8] In connection with the CFTC's Project KISS initiative, the International Swaps and Derivatives Association, Inc. ("**ISDA**") submitted a comment letter that requested increased transparency of CCP recovery plans so that "[clearing participants] can measure, manage and control their potential exposures." *See* ISDA, Comment Letter re: Project KISS; 82 Fed. Reg. 23765 (Sept. 29, 2017) ("**ISDA Project KISS Comment Letter**"), at 14.

than others to have correlated exposures or act as vectors for transmitting risk to other segments of the financial system. Whether additional transparency into recovery plans can address these issues is likely to depend on whether affected market participants fully internalize these risks or can effectively elect not to use a particular CCP, given prevailing levels of industry concentration and applicable regulatory mandates.

CCP Resolution

In a situation where a recovery plan has failed to maintain a CCP's operations, authorities will have to choose to either allow the CCP to fail or intervene. Under the latter choice, the failing CCP would in most cases be subject to orderly resolution under Title II of the Dodd-Frank Act, better known as "OLA." The White Paper encourages the Federal Deposit Insurance Corporation and the CFTC to provide more transparency of their intentions in a crisis so that market participants can manage their own risks in such a scenario and minimize spillover disruptions

SWAPS REPORTING RULES

Consistent with the CFTC staff's Reporting Roadmap, the White Paper recommends several changes to swap reporting rules, as described below:

- Verification of Data Accuracy and Completeness. The White Paper suggests that the CFTC update its regulations so that both swap data repositories ("**SDRs**") and swap counterparties verify swap data. One method suggested in the White Paper by which this could be accomplished would be to require SDRs to provide regular reports detailing the swap data in their records to the respective reporting counterparties. Such counterparties would then review these reports and either verify to the SDR that the data contained therein is accurate or indicate that it is not accurate and correct inaccuracies.

  The Reporting Roadmap had flagged for consideration "which counterparty(ies) must perform reconciliations." In a positive development, the White Paper implies that only the reporting counterparty should have this role.

- Validation of Incoming Data. The White Paper suggests that SDRs validate data as they receive it, noting that the European Securities and Markets Authority already requires a similar exercise with respect to swap reporting in the EU. This requirement would also impose an obligation on reporting entities to correct and resubmit data that fails a validation in a timely manner.

- Changes to Regulatory Reporting – Part 45. Consistent with the Reporting Roadmap, the White Paper recommends considering: (1) reducing the number of messages required to report a transaction; (2) adjusting the regulatory reporting deadline to T+1; and (3) implementing the data standards published by the Committee on Payments and Market Infrastructures ("**CPMI**") and International Organization of Securities Commissions ("**IOSCO**"). With respect to data standards in particular, the White Paper recommends removing uncertainty as to the form, manner and allowable values of required data elements and expanding those elements to include additional data regarding collateral/margin and valuation.

In addition to building on CPMI-IOSCO harmonization efforts, it will be important for the CFTC to coordinate the timing and substance of changes to its regulatory reporting requirements with changes, if any, made by the SEC and foreign regulators. Also, in connection with collateral/margin and valuation data, there may be opportunities for the CFTC, in coordination with the National Futures Association ("**NFA**"), to adjust existing and proposed risk exposure and metrics reporting rules to minimize the extent of duplicative reporting requirements.

- <u>Real-Time Public Reporting</u>. The White Paper recommends a pilot program to study the effects of altering the notional cap sizes, block sizes and time delays across different SEFs, asset classes, and/or special products.

Pilot programs are frequently costly and time-consuming to implement and can yield ambiguous results. In addition, given Chairman Giancarlo's stated intention not to seek reappointment, any resulting changes to public reporting rules following a pilot program are unlikely to occur under his tenure. In the meantime, as the White Paper acknowledges, there is a striking difference between the reporting regimes in the U.S., where the vast majority of swaps are disclosed publicly in real time, and Europe, where the vast majority of swaps are not subject to any public disclosure within days of trade execution. Thus, a potentially more important near-term issue is whether the CFTC will permit U.S. firms' European branches and affiliates to substitute compliance with European reporting rules.

- <u>Distributed Ledger Technology</u>. The White Paper is very supportive of regulators allowing innovation in the FinTech space and specifically extols the many virtues of distributed ledger technology ("**DLT**") and its potential use for trade reporting, even suggesting that the CFTC collaborate with other regulators to develop "regulator nodes" on distributed ledgers. On the other hand, the White Paper also identifies challenges with respect to certain aspects of DLT, including the lack of standardization, the need for adequate technology, expertise and resources to properly process information received through DLT, and the potential of security breaches, all of which would need to be addressed before serious consideration of the use of DLT at the regulator level could be given.

Given the need for inter-agency cooperation, including the SEC—which has been more wary of certain FinTech developments—the broad adoption of DLT or other FinTech innovations by regulators currently seems like a more distant possibility.

SWAPS EXECUTION RULES

The Dodd-Frank Act requires all swaps that are subject to the mandatory clearing requirement to be executed on a SEF or a designated contract market ("**DCM**"), unless no SEF or DCM makes the swap "available to trade" (the "**Trade Execution Requirement**"). Consistent with recommendations that then-Commissioner Giancarlo made in the 2015 Paper, the White Paper recommends significant reform to the CFTC's regulation of SEFs and its approach to the Trade Execution Requirement:

- Methods of Execution. The White Paper recommends eliminating requirements that (1) SEFs offer an order book and (2) swap transactions subject to the Trade Execution Requirement be executed by a SEF either through its order book or through a request for quote to at least three unaffiliated recipients.

Some have questioned whether permitting SEFs to offer more flexible methods of execution might lead European authorities to reconsider their decision in December 2017 to determine that the legal and supervisory framework applicable to DCMs and SEFs is equivalent to the framework applicable to European trading venues under the Market in Financial Instruments Regulation. Notably, that equivalence determination cites existing CFTC order book and request-for-quote requirements as among the factors relevant to the equivalence analysis.

- Proficiency Requirements and Conduct Standards. The White Paper suggests that, instead of prescribing methods of execution, the CFTC should focus on enhancing the professional conduct of swaps execution through licensure, testing, adoption and abidance of codes of professional conduct.

The White Paper observes that SEF rules have shifted swaps price discovery and liquidity formation away from SEFs to introducing brokers ("**IBs**"), which the White Paper notes are not subject to conduct, recordkeeping and compliance requirements appropriate for either swaps products or platform trading or whose employees are not required to pass proficiency exams for swaps markets. Query, however, whether NFA might be in a position to ensure that swaps IBs are subject to such appropriate requirements, as well as how any forthcoming SEF requirements might align with NFA initiatives in these areas.

- Made Available to Trade Determinations. The White Paper recommends eliminating the existing process through which SEFs and DCMs apply specified factors to determine whether a category of swaps is "available to trade" and instead applying the Trade Execution Requirement to all swaps subject to the CFTC's mandatory clearing requirement and listed by a SEF or DCM.

Currently, only those mandatorily cleared interest rate swaps and credit default swaps comprising the most liquid tenors are subject to the Trade Execution Requirement. Expanding the requirement to cover less liquid swaps could result in significant changes to market practices, especially for dealer-to-customer trading, even if SEFs are permitted to offer more flexible methods of execution. Such an expansion could raise questions about SEF listing standards (*e.g.*, will there be an adequate number of SEFs that list and can credibly support trading for every mandatorily cleared swap to ensure sufficient liquidity?) and SEF rules relating to pre-execution communications.

Swap Dealer Capital

Currently, swap dealers with a Prudential Regulator (*i.e.*, swap dealers that are banks) are subject to bank capital requirements based on the Basel Capital Accords. Capital rules covering non-bank swap dealers have been proposed by the CFTC but have not been finalized. The White Paper makes a number of observations with respect to both types of capital rules.

Use of Internal Risk-Based Models

The White Paper is critical of certain aspects of bank capital requirements, arguing that (i) some components of the bank capital regime inappropriately rely on swap notional amounts to measure risk; (ii) some components do not sufficiently recognize offsetting swap positions with a single counterparty; and (iii) the regime does not sufficiently acknowledge the full effect of risk mitigation of posted margin. Taken together, the White Paper asserts that the current bank capital regime is generally biased against risk taken through swaps transactions and proposes potential solutions to this issue.

The White Paper suggests that some of the biases against swap transactions inherent in the bank capital regime could be corrected if banking regulators relied more heavily on internal risk models used by banks and their swap dealer affiliates.

The White Paper's recommendation that banking regulators should rely more heavily on internal risk-based models will require support from, and implementation by, U.S. banking regulators. Such a need for broad regulatory synchronization could mean that any reforms in swap dealer capital rules could take some time to adopt and implement. In the meantime, however, the CFTC itself might consider permitting non-bank swap dealers to use internal risk-based models approved by other regulators to compute market and credit risk charges for purposes of CFTC capital requirements.

Net Liquidation Assets Approach

The White Paper is critical of the CFTC's and SEC's proposed Net Liquidation Asset Approach,[9] under which a non-bank swap dealer's capital would be required to exceed 8% of hypothetical initial margin. In particular, the White Paper notes that, when calculating this minimum capital requirement, netting is not allowed across cleared swaps, uncleared swaps, and uncleared security-based swaps, and that

[9] *See* "Capital Requirements of Swap Dealers and Major Swap Participants," 81 Fed. Reg. 91,252 (Dec. 16, 2016). *See, also*, Cleary Gottlieb, "CFTC Re-Proposes Capital Rules for Non-Bank Swap Dealers" (Jan. 20, 2017), available at https://www.clearygottlieb.com/news-and-insights/publication-listing/cftc-re-proposes-capital-rules-for-non-bank-swap-dealers.

disallowing risk-reducing netting does not create the proper incentives for market participants.

Commissioner Brian Quintenz's recent public remarks have indicated that reforms in this area are expected, potentially in the form of a re-proposed swap dealer capital rule from the CFTC.[10]

END-USER EXCEPTIONS

The Dodd-Frank Act provides for an end-user exception that excludes certain non-financial end users from the requirements to clear standardized swaps and to exchange margin on uncleared swaps. Under CFTC rules and no-action relief, specified types of small financial end users can also rely on these exceptions. The White Paper proposes that the CFTC codify this relief and extend additional relief to certain other financial end users whose swap activities do not pose systemic risk. The White Paper also states that the uncleared margin rules should be less prescriptive, arguing that such a measure would encourage "sound and innovative" risk management.

Relief for Small Bank Holding Companies

The CFTC staff has issued no-action relief to bank holding companies and savings and loan companies whose consolidated assets are no more than $10 billion. The White Paper suggests that the CFTC codify this relief and further suggests that the CFTC consider other additional, incremental regulatory changes that could further reduce unnecessary burdens on small bank holding companies.

Narrowing the "Financial Entity" Definition

The White Paper argues that additional types of financial end users should be able to avail themselves of the end-user exceptions from clearing and margin requirements. It further suggests that the CFTC consider narrowing the definition of "financial entity" under CFTC regulations to provide relief to a broader range of financial end users, including treasury affiliates, certain types of special purpose vehicles, and perhaps certain energy firms.

The White Paper's recommendations to reduce certain regulatory burdens currently imposed on financial end users directly addresses some of the concerns raised in the Treasury Report, wherein the Treasury specifically suggested that it would support a legislative amendment to provide the CFTC with the rulemaking authority to modify and clarify the scope of the financial entity definition and the treatment of affiliates.[11] Even without statutory changes, however, the CFTC's plenary exemptive authority would allow it to exempt certain entities from the "financial entity" definition, which would expand the scope of the clearing and margin exceptions for hedging transactions.

[10] "Remarks of Commissioner Brian Quintenz before the Structured Finance Industry Group Vegas Conference" (Feb. 26, 2018), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz7 ("The Commission has an opportunity to further refine its proposed capital calculations to better reflect the true risk of the swap dealer's exposure and ensure that a firm's capital requirement is proportionate to its risks.").

[11] *See* Treasury Report at 142 ("Treasury would support a legislative amendment to [the Commodity Exchange Act] Section 2(h)(7) providing the CFTC with the rulemaking authority to modify and clarify the scope of the financial entity definition and the treatment of affiliates.").

Margin Thresholds

Under existing margin rules for uncleared swaps, there is a $50 million threshold amount for initial margin, below which initial margin is not required to be posted. The White Paper suggests that a variation margin payment threshold should also be considered.

Further, for financial end-users, initial margin requirements apply based on a "material swaps exposure" ("**MSE**") threshold calculation, currently set at an $8 billion gross notional amount of non-cleared swaps, security-based swaps, foreign exchange swaps, and foreign exchange forwards. Financial end-users with thresholds below this notional amount are not required to exchange initial margin. The White Paper argues that using a gross notional amount to set the MSE threshold ignores the fact that a financial end user might have long and short positions that offset against each other. The White Paper instead suggests that regulators consider changing the threshold from a gross notional threshold to a netted one, such as a ratio of Entity-Netted Notionals ("**ENNs**") to a financial end user's assets, so as to provide for a more risk-based measure of swaps activity. Under the ENNs approach, long and short positions between the same legal counterparties would be netted within product classes and within currencies.

These White Paper proposals align with the Treasury's recommendation that the "CFTC…should reconsider the one-size-fits-all treatment of financial end users for purposes of margin on uncleared swaps and tailor [its] requirements to focus on the most significant source of risk."[12]

Calculation of Initial Margin Requirements.

The White Paper indicates that the CFTC's current rules for uncleared margin are aimed inappropriately at promoting clearing. As an example, the White Paper notes that the uncleared margin rules prescribe collection of margin sufficient to cover ten days of market risk before a position is liquidated, a ten-day margin period of risk ("**MPOR**"), whereas collection of margin at clearinghouses only needs to cover a five-day MPOR.[13] The White Paper focuses on the fact that the initial margin requirements are calibrated at a punitive level, rather than a level commensurate with the actual risks posed by such swaps.

To address this issue, instead of prescribing an MPOR, the White Paper argues for that initial margin requirements be calibrated to cover a 99 percentile adverse event. Market participants could then create business-specific models, which would have to be approved by the appropriate regulators. Regulators could also continue offering simple, conservative models for those market participants that choose not to develop their own internal models or invest in third-party models. Such an approach would prevent a convergence of models, since, over time, such a convergence could result in an accumulation of risk in products that are inadvertently treated too leniently by the model that becomes the most prevalently used. Such

[12] Treasury Report at 130.

[13] *See* ISDA Project KISS Comment Letter at 27 ("The minimum liquidation periods should be revised to accurately reflect the liquidity profile of the underlying instruments and should not be arbitrarily based on the type of transaction").

model herding, the White Paper argues, may itself become a source of systemic risk.

The punitive nature of initial margin requirements has long been a concern of market participants. However, the CFTC is unlikely to act alone to address this concern. Indeed, the White Paper stresses that recommendations relating to margin requirements would need to be implemented in coordination with other domestic regulators and international counterparts.

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