

Trump Administration Outlook CFTC Regulatory Reform Swaps Trading Blueprint

January 19, 2017

CFTC; Derivatives

One of the most sweeping changes brought about by the Dodd-Frank Act¹ was the introduction of a new regulatory framework for swaps trading. In 2013, the Commodity Futures Trading Commission (“CFTC”) finalized its rules on swap execution facilities (“SEFs”) and swaps trading on SEFs. Less than four years after these rules were finalized, the change in Presidential Administration will result in a change in leadership at the CFTC, which means the CFTC will revisit the swaps trading regime implemented in 2013.

In particular, Commissioner J. Christopher Giancarlo has criticized the CFTC’s implementation of Dodd-Frank’s regulatory framework for swaps, and in 2015 published a white paper detailing these criticisms and suggesting reforms to the CFTC’s swaps trading rules.² Commissioner Giancarlo recently referenced this white paper and noted the CFTC swaps trading regulatory framework has resulted in fragmentation of global financial markets. Commissioner Giancarlo stated that this fragmentation is “caused by ill-designed rules and burdensome regulations—and the application of those rules abroad—is harming market liquidity and market safety and soundness, increasing the systemic risk that the Dodd-Frank Act was predicated on reducing.”³ Therefore, Commissioner Giancarlo said:

The time has come for the CFTC to revisit its flawed swaps trading rules to better align them to market dynamics, allow U.S. swap intermediaries to fairly compete in world markets and reverse the tide of global market fragmentation.

Commissioner Giancarlo, the sole Republican Commissioner, will be named Acting Chair when current Chairman Timothy G. Massad steps down on January 20, 2017, and may be the candidate for permanent Chair. In the coming months, the CFTC is likely to look to Commissioner Giancarlo’s white paper to provide a blueprint for changes that can be made to the CFTC’s swaps trading regime. In a speech given on January 18, 2017, Commissioner

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

² J. Christopher Giancarlo, Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank (Jan. 29, 2015) (hereinafter “Swaps Trading White Paper”).

³ Keynote Address of CFTC Commissioner J. Christopher Giancarlo before the ISDA’s Trade Execution Legal Forum (Dec. 9, 2016), available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-18>.

Giancarlo reiterated his commitment to the principles in his white paper, and indicated that as Acting Chair he intends to “move forward with the proposed alternative regulatory framework for swaps trading” that were detailed therein.⁴ The purpose of this alert is to revisit and summarize that white paper, which may give market participants a forecast of the shape the CFTC’s swaps regime might take under Republican leadership.

Commissioner Giancarlo’s Criticisms

In his white paper, Commissioner Giancarlo notes that he is generally in favor of Dodd-Frank’s regulatory framework for trading swaps.⁵ However, he criticizes the CFTC’s implementation of that framework, arguing that the CFTC unwisely modeled its swaps trading rules after the futures regulatory framework, despite the significant differences in the two markets.⁶ According to Commissioner Giancarlo, this has led to a regulatory framework that is in many respects, unnecessarily inflexible and complex, in direct contradiction to the flexible, simple approach contemplated by the Dodd-Frank Act. Below we summarize the concerns raised by Commissioner Giancarlo and the reasoning behind his criticisms:

- **Unnecessary Limitations on Execution Methods:** The CFTC’s SEF rules categorize swaps transactions as either Required Transactions (those subject to the trade execution requirement) or Permitted Transactions (those not subject to the trade execution requirement). The rules further provide that Required Transactions can only be executed via an Order Book or a request for quote sent to at least three participants (RFQ-3) operating in conjunction with an order book. However, the Dodd-Frank Act does not support fragmenting swaps into two different transaction types, and does not support limiting the execution methods for one of those types. Instead, it allows execution “through any means of interstate commerce,” because Congress recognized that the episodic liquidity of swaps transactions requires that market participants have flexibility in execution methods.⁷
- **Block Transaction “Occurs Away from SEF” Requirement:** The CFTC’s definition of a block trade includes the provision that it “occurs away” from a SEF. This is a pointless distinction between regular trades that occur “on-SEF” and block trades that occur “off-SEF,” and “undermines the legislative goal of encouraging swaps trading on SEFs.”⁸

⁴ Keynote Address of CFTC Commissioner J. Christopher Giancarlo before SEFCON VII (Jan. 18, 2017), available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-19>. In his address, Commissioner Giancarlo also committed to addressing swaps data reporting, cross-border harmonization, encouraging technological innovation, and adopting a more forward-thinking approach to regulation. Throughout his address, Commissioner Giancarlo emphasized reducing regulatory burdens, increasing flexibility, and a more cooperative approach to regulation. Commissioner Giancarlo will become Acting Chair on January 20, 2017.

⁵ Swaps Trading White Paper at 20 (“In crafting Title VII of the Dodd-Frank Act, Congress got much of it right.”).

⁶ *Id.* at 21.

⁷ *Id.* at 21-27.

⁸ *Id.* at 27-28. The CFTC Staff has provided time-limited no-action relief for this requirement, which is set to expire on November 15, 2017. See CFTC Letter No. 16-74 (Oct. 7, 2016).

- Ill-Advised “Made Available to Trade” Process: The Dodd-Frank Act generally requires that swaps subject to the clearing mandate must also be executed on a SEF, unless no SEF “makes the swap available to trade,”⁹ a provision the CFTC implemented with a made-available-to-trade (“MAT”) process that allows a single SEF to subject a swap to the Federal trade execution requirement by certifying to the CFTC that the swap is MAT under Part 40 of the CFTC’s regulations, after which the swap becomes a Required Transaction as to all SEFs.¹⁰ This process, which allows a single SEF to require that all SEFs offer trading in a swap only via an Order Book or RFQ-3 in conjunction with an Order Book, is not supported by Dodd-Frank and “fails to effectively guard against inadequate trading liquidity.”¹¹
- Conflating “Impartial Access” With “All-to-All” Access: While the Dodd-Frank Act requires that SEFs have rules to provide market participants with impartial access to the market, it also required that SEFs establish rules regarding any limitation to access. Thus, Congress did not intend that “impartial access” mean SEFs should be “forced to serve every type of market participant.” The CFTC’s insistence on imposing an “all-to-all” market structure on SEFs is at odds with the existing, well-formed structure of the swaps market, which includes distinct dealer-to-customer and dealer-to-dealer markets that naturally developed as a result of the nature of swaps trading.¹²
- Ill-Advised Void *Ab Initio* Rule: The CFTC’s guidance stating that any swap trade executed on a SEF and rejected from clearing is void *ab initio* ignores the possibility that a transaction could be rejected from clearing simply due to an operation or clerical error. It also introduces unnecessary risk into the system, as participants who enter into swaps to hedge the risk of a swap that is rejected from clearing will find themselves with unhedged risk.¹³
- Uncleared Swaps Confirmations: The CFTC’s rules require that SEFs provide counterparties with “a written record of all of the terms of the transaction which shall legally supersede any previous agreement and serve as a confirmation of the transaction.”¹⁴ However, SEFs will not have access to “all of the terms” of the agreement, because SEFs do not own the products and swaps market participants rely on master agreements (such as the ISDA Master Agreement) that govern the overall trading relationship. Instead of requiring that SEFs provide “all of the terms” of the

⁹ Commodity Exchange Act (“CEA”) § 2(h)(8); 7 U.S.C. § 2(h)(8).

¹⁰ 17 C.F.R. § 37.10.

¹¹ Swaps Trading White Paper at 29-32. The CFTC may deny the MAT designation, but Commissioner Giancarlo argues this is unlikely since there are no “objective requirements a swap must meet for a MAT determination to be valid.” *Id.* at 29. Chairman Massad has recently acknowledged that the MAT process should be reviewed to make the CFTC the determining body for a swaps trading requirement and also to align with the process in Europe under MiFID II/MiFIR framework. See Keynote Remarks of Chairman Timothy Massad Before the Futures Industry Association Futures and Options Expo (Oct. 19, 2016), available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-49>.

¹² Swaps Trading White Paper at 32-33.

¹³ *Id.* at 33-34. The CFTC has issued a series of no-action letters to allow swaps rejected from clearing due to operational or clerical errors to be resubmitted. *See, e.g.* CFTC Letter No. 16-58 (June 10, 2016).

¹⁴ 17 C.F.R. § 37.6(b).

transaction in confirmations, SEFs should only be required to provide the fundamental economic terms.¹⁵

- **Embargo Rule and Name Give-Up:** The CFTC's rules restrict SEF disclosure of swap transaction and pricing data to market participants until such data is transmitted to a swap data repository for public dissemination. The delay caused by this requirement inhibits the "work-up" process which allows counterparties to transact in additional quantities of the swap immediately after execution at a price matching that of the original trade, a process which introduces much needed liquidity. Moreover, this requirement interferes with "name give-up," through which identities of counterparties are disclosed after they have been anonymously matched by a platform. While there may be reasons to curtail the use of name give-up, particularly as clearing becomes more prevalent, it should not be done until after a full analysis is conducted.¹⁶
- **Prescriptive Rules Disguised as Core Principles:** In contrast to the CFTC's reputation as a principles-based regulator that identifies goals to be achieved rather than prescribing the means to achieve them, the SEF core principles are unnecessarily prescriptive. For example, under SEF Core Principle 2 (Compliance with Rules), the CFTC has rules that allow only one warning letter to be issued by the SEF to the same person or entity that has committed the same violation within a rolling twelve month period, which undermines the ability of a SEF to exercise reasonable discretion and to take disciplinary action based on the totality of the circumstances.¹⁷

According to Commissioner Giancarlo, these missteps have led to a variety of negative consequences, including fragmenting the global swaps market and hindering technological innovation in the U.S. swaps market. Ultimately, these rules drive swaps activity out of the U.S., undermines market liquidity, costs U.S. jobs, and ultimately threatens the very survival of SEFs.¹⁸ It also taxes the resources of the CFTC, which must continually issue no-action letters and other guidance to address the unintended consequences of its rules.¹⁹

Proposed Swaps Trading Framework

To remedy these problems, Commissioner Giancarlo proposes a swaps trading regulatory framework based around five key tenets: (1) Comprehensiveness; (2) Cohesiveness; (3) Flexibility; (4) Professionalism; and (5) Transparency.

Comprehensiveness

Commissioner Giancarlo agrees that a "comprehensive range of U.S. swaps trading activity" should be "subject to CFTC oversight," and thus is in favor of the CFTC's "broad SEF registration requirement."²⁰ However, he proposes that this comprehensive approach should be

¹⁵ Swaps Trading White Paper at 34-36. CFTC Staff has issued time-limited relief related to the confirmation requirement, which expires on March 31, 2017. See CFTC Letter No. 16-25 (April 22, 2015), available at: <http://www.cftc.gov/idc/groups/public/@llettergeneral/documents/letter/15-25.pdf>.

¹⁶ Swaps Trading White Paper at 36-39.

¹⁷ *Id.* at 40-47.

¹⁸ *Id.* at 48-55.

¹⁹ *Id.* at 57 and *supra* n. 3.

²⁰ Swaps Trading White Paper at 63.

implemented “in a clear and direct manner” through rules “and not buried in footnotes in the preamble text.”²¹

Cohesiveness

Commissioner Giancarlo argues for cohesion in the swaps regulatory framework. This would include removing the artificial distinction between Required Transactions and Permitted Transactions, along with the differential execution methods allowed for each. In addition, under this tenet, there would be no requirement that block trades occur away from the SEF. Thus, “all CFTC-regulated swaps trading” would “fall within the same, cohesive and undivided regulatory framework.”²²

Flexibility

Commissioner Giancarlo argues that the Dodd-Frank Act contemplated flexibility in swaps trading, and that the CFTC’s rules have instead imposed rigidity. Commissioner Giancarlo’s proposed framework would allow for a return to Dodd-Frank’s flexibility in the following five areas:

- **Trade Execution:** Commissioner Giancarlo would remove the limitations on execution methods, instead allowing market participants to choose the execution methods “best suited to their swaps trading and liquidity needs.”
- **Evolution of Products:** Commissioner Giancarlo would abandon the current MAT process and allow “new and novel swaps products develop commercially to the point where market participants naturally turn to platforms to offer trading in the product.”
- **Market Structure:** Commissioner Giancarlo would abandon the “all-to-all” approach he argues has been imposed by the CFTC, and would instead allow SEFs to offer services to the segments of the market segment they are best qualified to serve.
- **Accommodate Beneficial Swaps Market Practices:** Commissioner Giancarlo’s approach would accommodate established, beneficial market practices. For example, Commissioner Giancarlo would let SEFs determine how to address swaps that are rejected from clearing and would narrow the scope of trade confirmations. This approach would also allow for continuation of commercial practices that have developed as a result of the unique nature of the swaps market, including the use of third-party service providers such as trade data vendors and the use of services such as compression and risk reduction services.
- **Actual Core Principles:** Commissioner Giancarlo would treat core principles as guidance, rather than as prescriptive rules in themselves.²³

Raising Standards of Professionalism

Commissioner Giancarlo argues that the 2008 financial crisis did not particularly necessitate the regulation of swaps trading and execution. However, recent scandals do, and further indicate the need for higher standards of qualification for swaps professionals. He argues that the CFTC

²¹ Id. at 64.

²² Id.

²³ Id. at 65-69.

should set specific standards for the conduct of swaps professionals. He points out that securities professionals must pass the Series 7 exam, and that futures professionals must pass the Series 3 exam, but that there is no corresponding proficiency requirement for swaps professionals. While the CFTC imposes obligations on SEF employees, there is no formal process for ensuring that employees have the skills and knowledge to meet those obligations. Commissioner Giancarlo's approach would impose one.²⁴

Transparency

While Commissioner Giancarlo acknowledges that pre- and post-trade price transparency can enhance market liquidity, he also contends that excessive transparency can *harm* liquidity, which he argues has occurred as a result of the requirement that SEFs offer an Order Book or RFQ-3 system. To that end, he argues that the CFTC should focus on enhancing liquidity, including by allowing a variety of execution methods such as work-up and auctions. He believes this will lead to enhanced price transparency, whereas a myopic focus on transparency will actually decrease it.²⁵

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Covington has prepared an Appendix to this alert that identifies each rule applicable to SEFs and highlights any anticipated changes to the rule. The appendix is available upon request.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our CFTC Practice Group:

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²⁴ Id. at 70-74.

²⁵ Id. at 74-76.