Debevoise In Depth

CFTC Chairman Publishes White Paper: Swaps Regulation Version 2.0

May 31, 2018

On April 26, 2018, Chairman J. Christopher Giancarlo of the Commodity Futures Trading Commission (the "CFTC") released a white paper, co-authored with CFTC Chief Economist Bruce Tuckman, titled "Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps" (the "White Paper").[1]

Based on their analysis of the data and experience gathered during the past four years, the authors of the White Paper assess the CFTC's implementation of current swap regulations (referred to as "Version 1.0") by taking a look at five key areas: (1) swaps clearing, (2) swaps reporting, (3) swap execution, (4) swap dealer capital and (5) the end-user exception from clearing and margin rules and related requirements.

Debevoise & Plimpton

Swaps Clearing

The White Paper analyzes the CFTC's current swap clearing framework, citing the benefits of existing safeguards, such as financial resources and risk management requirements applicable to clearing members, initial margin collected by central counterparties ("CCPs"), additional prefunded resources (*i.e.,* guarantee fund contributions; CCP "skin-in-the-game"), unfunded resources (*i.e.*, "assessments" from clearing members) and the waterfall allocating losses across resources. The authors conclude that the CFTC's implementation of the clearing mandate has been largely successful and that significant progress has been made toward ensuring the safety and soundness of CCPs and toward establishing credible CCP recovery plans.

However, the authors stress the importance of continued vigilance and the need for improvements in the following areas:

[1] The White Paper is available at: https://www.cftc.gov/PressRoom/PressReleases/7719-18].

- *Ensuring the liquidity of prefunded resources*: The authors note that there are risks associated with cash deposited with banks (in case of bank failures) and cash invested in repurchase agreements (in case of counterparties' failures). Thus, they call for diversifying exposures to depositories and repo counterparties and monitoring and managing the liquidity risk of securities holdings. The authors also raise the following policy questions:

  - While the Dodd-Frank Act permits CCPs designated as "systemically important" to deposit funds directly with the Federal Reserve, should smaller CCPs and potential CCP entrants also be offered the same access to the Federal Reserve?

  - In addition, while the Federal Reserve may make collateralized loans to systemically important CCPs "in unusual or exigent circumstances," does such last-resort lending "encourage unhealthy market concentration," and if so, should a similar safety net be extended to smaller CCPs and potential entrants?

- *Correlated defaults and network effects*: The authors stress the importance of being able to study the correlations across positions at multiple financial institutions and providing an analysis of the networks of relationships that might spread defaults across the system. Noting the challenges arising from the fact that a CCP's information is generally limited to the exposures of its own members and that the CFTC lacks information on non-derivatives exposures, the authors stress the need for continued attention and research into such correlated defaults and network effects.

- *Liquidation costs of defaulted positions*: The authors note that CCPs collect margin to protect themselves against the liquidation costs associated with the default of a clearing member. Therefore, the authors state that the margin charge for liquidation costs should continue to be scrutinized and that new products should be accepted for clearing only if CCPs are able to quantify their replacement costs under difficult market conditions.

- *CCP recovery and resolution*: The White Paper points to several areas of challenges with respect to CCP resolution, including enhancing the transparency and predictability of recovery plans, addressing the uncertainties associated with assessments and ensuring regulators do not impose overly prescriptive rules for recovery plans. With respect to the resolution of any CCP, the authors also stress the importance of transparency and coordination between the CFTC and the Federal Deposit Insurance Corporation.

Swaps Reporting Rules

The White Paper points to improvements in market transparency and swap data integrity since the publication of the swap data reporting rules in 2012.[2] However, the authors note that the reporting structure remains incomplete and the CFTC rules do not provide sufficient technical specificity as to the exact information to be reported.

The authors note that CFTC staff has begun the process of assessing and improving the reporting rules, outlining the path forward in its July 2017 "Roadmap to Achieve High Quality Swaps Data." The White Paper proposes improvements in the following areas:

- *Verification and Data Accuracy and Completeness*: The authors propose to require both swap data repositories ("SDRs") and reporting counterparties to perform the verification of swap data (for instance, by requiring SDRs to provide regular reports to reporting counterparties detailing swap data they maintain, which data would be reviewed and verified (or disputed) by the counterparties, similar to the portfolio reconciliation process).

- *Validation of Incoming Data*: The authors propose requiring SDRs to validate data as it arrives, in a unified and consistent manner, citing similar requirements in the European Union.

- *Changes to Part 43 (Real-Time Public Reporting)*: Noting the uncertainties surrounding block trade classification, the authors propose a pilot program to study the effects of varying cap sizes, block sizes and time delays, potentially across different swap execution facilities ("SEFs"), asset classes and/or specific products. Further, the authors stress that any modifications to the rules regarding block sizes, cap sizes and dissemination delays should be tailored to specific products, entities, markets and asset classes, rather than imposing a one-size-fits-all approach.

- *Changes to Part 45 (SDR Reporting)*: The authors point to a lack of specificity in the Part 45 requirements with respect to required data fields or the manner in which swap terms are to be represented within such fields when they are reported to SDRs. The authors suggest allowing additional time for counterparties to submit fewer swap messages per transaction, and moving to a T+1 reporting time frame consistent with reporting requirements in the EU. Finally, the authors advocate newly defined

[2] The authors cite recent steps the CFTC has taken in cooperating with international regulators to harmonize technical guidance, including the CFTC's role as co-chair of the CPMI-IOSCO Harmonization Group, which recently published detailed technical guidance regarding unique transaction identifiers (UTIs) and unique product identifiers (UPIs).

data fields and allowable values to remove uncertainty, and additional data elements for collateral/margin and valuation data fields to help address systemic risk.

- *Distributed Ledger Technology*: The authors note that blockchain technology will most likely be adopted for reporting and recordkeeping in financial markets in the future. Therefore, they call for collaboration among the CFTC and other authorities to cultivate the development of "regulator nodes" on distributed ledgers (to produce a single, validated record of all financial transactions across regulated markets) and for subjecting blockchains used for data reporting to uniform standards to allow regulators to access and utilize the reported data.

Swaps Execution Rules

The White Paper aims its strongest critiques of existing swaps regulations at the current swaps execution rules. The authors assert that Congress deliberately chose not to mandate that a swap execution facility ("SEF") utilize any particular method of trading or execution by defining the term "swap execution facility" broadly to refer to swaps executed "through any means of interstate commerce."

The authors believe that the CFTC's swap execution rules are contrary to the Congressional intent and have "stunted" SEF trading by: (1) arbitrarily confining SEF execution to two methodologies (Order Book and "RFQ-to-3" systems); and (2) adopting an overly narrow definition of the phrase "made available to trade" ("MAT") that unnecessarily limits the swaps that are required to be traded on SEFs. In addition, they note that the CFTC grafted into its SEF rules a number of market practice rules from the futures regulatory framework that are "antithetical to swaps trading," such as establishing a 15-second "cross-trade" requirement and permitting off-SEF execution of block trades.

The authors argue that the existing framework has yielded unintended consequences, incentivizing a significant amount of price discovery and liquidity formation to take place off-SEF while also fragmenting swaps trading into numerous artificial market segments, increasing liquidity risk and hindering technological innovation. In general, the authors argue that instead of trying to determine SEFs' swaps execution business model, the CFTC should focus on raising standards of conduct for swaps trading. They propose the following changes:

- Permitting SEFs to offer any means of interstate commerce;[3]
- Eliminating the requirement that all SEFs maintain an Order Book for swaps subject to mandatory SEF execution; and
- Eliminating the MAT process and expanding the category of swaps subject to mandatory SEF execution to include all swaps subject to mandatory clearing, unless no SEF (or designated contract market) lists the swap for trading.

Swap Dealer Capital

In their evaluation of the existing capital, liquidity and leverage requirements applicable to swaps, the authors argue that several components of today's bank capital requirements overestimate risks relating to swaps. In particular, they note that the reliance of the current requirements on swap notional amount to measure risk is inadequate because it does not sufficiently recognize offsetting swap positions with a single counterparty[4] and does not sufficiently acknowledge the risk mitigation of margin.

The authors note that regulators have developed the "Standardized Approach for Counterparty Credit Risk" (SACCR) as a replacement for the Current Exposure Method ("CEM")[5]. The authors acknowledge that the SACCR computes potential exposure in a more strongly risk-based manner than the CEM, but take issue with the overly rigid assumptions underlying this model and the limitations on the use of margin to offset potential swap exposures.

---

[3] The authors note that other jurisdictions have not adopted this restrictive approach in their regulations, placing the United States at a competitive disadvantage as U.S. markets are restricted from promising new execution methodologies.

[4] The authors note that the "questionable treatment of netting" also appears in the CFTC's (and SEC's) capital rules for nonbank swap dealers—in particular, the Net Liquid Asset Approach, in which netting is not allowed across cleared swaps, uncleared swaps and uncleared security-based swaps in calculating the amount of hypothetical margin against which net assets are measured.

[5] The authors criticize the CEM for overstating potential future exposures by unduly limiting offsets of long and short positions and not allowing margin collected to offset such potential exposures. They also note that the CEM has had the unintended consequence of reducing capital requirements for swaps in a risk-insensitive manner due to the treatment of variation margin of cleared swaps as settlement (in an effort to counteract the CEM's "punitive" treatment of swaps). With respect to the SLR, the authors note that a "quirk" of this regulation has been to cause firms to push margin deposits off balance sheet (as such margin deposits would otherwise have the "perverse" effect of increasing required capital), which may pose efficiency costs for dealers and their customers.

The authors further advocate greater reliance on banks' internal models, which they note "tend to be carefully risk-based." As internal models are usually built around sensitivities to various risks (*e.g.*, interest rate shocks, credit spreads) or around other risk measures (*e.g.*, volatility, VaR), the authors note that they generally assess swaps risks comparably to risks of other assets. Unlike standardized models, internal models tend to recognize that notional amount is not representative of credit risk and that netting and margin are integral to managing and mitigating swaps risks.

End-User Exception

Finally, the authors propose the following improvements to further implement the Congressional intent of creating a robust end-user exception from the swap clearing and margin requirements:

- *Small Bank Exemption*: The White Paper calls for the CFTC to codify into rules its existing no-action relief applicable to bank holding companies and savings and loan holding companies with less than $10 billion in consolidated assets (expanding on the existing regulation permitting depository institutions with less than $10 billion in assets to claim the end-user exception). The authors also call for the CFTC to consider further reducing burdens on such small financial institutions by additional, incremental regulatory changes.

- *Material Swaps Exposure Threshold and Financial Entity Definition*: To reduce the burdens on financial end users that are not sources of systemic risk, the authors propose that the CFTC consider:

    - Establishing material swaps exposure thresholds below which entities would be excepted from variation margin requirements;

    - Reworking the existing material swaps exposure ("MSE") threshold for initial margin requirements to be based on "Entity-Netted Notionals" ("ENNs"), which, unlike the current notional amount calculation, would net long and shorts within pairs of legal counterparties, within product classes and within currencies;[6] and

[6] The authors propose an additional threshold based on the ratio of ENNs to assets in order to "capture the complexity of a business with respect to swaps." The intention is to exempt entities whose swaps positions are small relative to the size of their businesses (even where such positions exceed the MSE threshold on an absolute basis).

- Narrowing its interpretation of the definition of "financial entity" to bring additional clarity and relief to certain end users, including treasury affiliates, certain types of special purpose vehicles and some energy firms.

- *Overly Prescriptive Margin Rules*: The authors call for initial margin rules for uncleared swaps to be reworked to be less prescriptive and to be unbiased with respect to cleared and uncleared products.

Timeline for Implementation

In response to questions about the timeline of implementation of the ideas set forth in the White Paper, Chairman Giancarlo stated: "I'm committed to a process in rule writing which is 'ready, aim, fire.' I think sometimes, regulators can use the 'ready, fire, aim' approach. I'm committed to a deliberative process and getting back to regular order at the agency. We're not in the wake of a crisis right now—we need to take the time to get this right."

* * *

Please do not hesitate to contact us with any questions.

NEW YORK

Byungkwon Lim
blim@debevoise.com

Emilie T. Hsu
ehsu@debevoise.com

Aaron J. Levy
ajlevy@debevoise.com