

CFTC Chairman Giancarlo's White Paper on Swap Regulation Reform Envisions Near-Term Changes and Longer-Term Enhancements

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CFTC Chairman J. Christopher Giancarlo and CFTC Chief Economist Bruce Tuckman released a [White Paper](#) on April 26, 2018 that reflects the authors' personal views on the need for swaps regulatory reforms in the United States in five key areas:

1. swap execution on swap execution facilities ("SEFs");
2. trade reporting;
3. central counterparty clearing;
4. swap dealer capital; and
5. end user exception to clearing and margining for uncleared swaps.

The White Paper contains a mix of specific reform ideas that are expected to be reflected in rule proposals in the near future – such as changes to the SEF rules – and more abstract discussions of policy shortcomings that the Chairman is content to allow to percolate in the marketplace, with no immediate plans to act. [1] The White Paper is the second such document authored by Chairman Giancarlo, the first being a critique of the SEF rules that was issued when he was a minority Commissioner in 2015. [2] The more recent White Paper is unusual in that it purports to represent the Chairman and Chief Economist's personal views, as opposed to Commission views, but is backed by the weight of the Chairmanship. Indeed, its issuance appears to have rankled the minority Commissioner, who noted that "adding another white paper just pushes back the timeline for getting to actual deliverables [and] ... takes a lot of staff time when budgets are tight." [3]

Within days of the White Paper's release, the Chairman announced that he does not intend to seek reappointment when his term ends in April 2019. Thus, any reforms that are not proposed by the CFTC in the short term, or that require coordination with other domestic or international agencies, are unlikely to be realized during the Chairman's term.

Below is a more detailed discussion of topics and reform proposals discussed in the White Paper.

1. Swap Execution on SEFs

White Paper Assessment: The White Paper's most concrete reform recommendations relate to the CFTC's swap execution rules, consistent with Chairman Giancarlo's prior criticisms of the prescriptive nature of the current SEF trading and execution rules [4] (i.e., the Order Book and RFQ-to-3 requirements). In addition, the White Paper criticizes the "made available to trade" process, which, according to the Paper, together with the SEF trading rules have frustrated the goal of subjecting a broader range of swaps products to be SEF traded.

Suggested Next Steps and Reforms: The White Paper suggests that the CFTC permit SEFs to offer any method of execution for trades subject to the trade execution requirement. This change is intended to allow market participants to innovate and adopt more efficient methods of execution, consistent with developments in the corporate bond and Treasury markets. The White Paper also proposes eliminating the "made available to trade" process and expanding the category of swaps subject to the trade execution requirement to include all swaps that are subject to the CFTC's clearing

mandate.

Timing: DMO Director Amir Zaidi has publicly stated that he hopes to have a rule proposal on trade execution ready for Commission action as early as July of this year.

2. Trade Reporting

White Paper Assessment: The White Paper points out that a decade after the financial crisis, SDRs still cannot provide regulators with a complete and accurate picture of counterparty credit risk in global swaps markets, which the Paper characterizes as particularly disappointing given that gaining visibility into counterparty credit risk of major financial institutions was one of the most pressing reform needs following the 2008 financial crisis. The authors state that further research and analysis is required to refine current one-size-fits-all rules on block trades, to properly calibrate the competing goals of transparency and liquidity among different products, entities, markets and asset classes.

Suggested Next Steps and Reforms: The White Paper suggests that, in addition to efforts already underway through the CFTC's [2017 Roadmap to Achieve High Quality Swaps Data](#), the reporting rules could be enhanced: (i) if the CFTC more clearly required the SDR and the reporting counterparty to verify swaps data, similar to a portfolio reconciliation exercise; (ii) if SDRs were required to validate all data as it arrives, similar to the validation that is currently required by the European Securities and Markets Authority; and (iii) if market participants were provided with additional time to submit fewer swap messages per transaction, with each message containing a more defined list of data fields describing the swap. The White Paper also proposes a pilot program to study the effects of varying cap sizes, block sizes and time delays on the liquidity of different asset classes and products, to generate a more nuanced and data-driven set of proposals on balancing the needs of public transparency and trading liquidity.

Timing: Uncertain, although the work of the CFTC staff and the discussions with market participants suggest the CFTC could propose in a rulemaking at least some of the suggested changes to the swaps data and reporting rules in the foreseeable future.

3. Central Counterparty Clearing

White Paper Assessment: The White Paper notes that the CFTC's clearing mandate was highly successful but as the volume of swap transactions cleared through central counterparties ("CCPs") has dramatically increased, several challenges have arisen that require further consideration, particularly around the safety and soundness of CCPs.

Suggested Next Steps and Reforms: The authors recommend further analysis to ensure that CCPs are safe and sound under extreme, but plausible, conditions and that further analysis be done to: (i) ensure the liquidity of funded resources; (ii) understand correlated details and network effects; and (iii) properly account for liquidation costs, particularly for new products.

Timing: Likely long term, particularly as reforms would require coordination with other U.S. and non-U.S. regulators.

4. Swap Dealer Capital

White Paper Assessment: The White Paper sets out in detail the myriad ways in which, according to the authors, the current bank capital regime is biased against the risks taken through swaps markets. Because around 50% of the approximately 100 CFTC-registered swap dealers are banks and an additional 30% of those 100 or so swap dealers are subsidiaries of bank holding companies, the bank capital regime is highly relevant to CFTC-registered swap dealers. In particular, the authors describe key components of the bank capital regime that, in their view, inappropriately rely on the swap notional amount to measure risk, do not sufficiently recognize offsetting swap positions with a single counterparty, and do not sufficiently acknowledge the risk mitigation of posted margin.

Suggested Next Steps and Reforms: The White Paper does not elaborate at length on specific recommendations to address the identified biases, but is generally favorable to the increased use of internal models as opposed to further attempts by regulators to refine their standardized approaches.

Timing: Likely long term, given the absence of specific recommendations and need for involvement of U.S. banking regulators.

5. End User Exception to Clearing and Margining for Uncleared Swaps

White Paper Assessment: This section of the White Paper reexamines the decisions made by regulators in seeking to exclude end users from mandatory swap clearing and margin and concludes, among other things, that smaller financial end users that are not sources of systemic risk should be exempt from clearing and uncleared swap margin requirements, through a re-conceptualized material swaps exposure threshold.

Suggested Next Steps and Reforms: The White Paper reiterates the Chairman's previously expressed view that the material swaps exposure threshold – below which financial entities are excepted from uncleared swap initial margin requirements – is an inadequate measure of swaps exposure because it is based on notional amounts, which add offsetting long and short positions together. The authors recommend that the material swaps exposure threshold be reworked to use units more meaningful than notional amounts, such as the CFTC's recently announced Entity-Netted Notionals. The authors argue that the reworked thresholds be applied to exempt smaller financial entities from variation margin requirements (not only initial margin requirements), as well as from the mandatory clearing requirement.

Timing: Likely long term. The White Paper notes that it will be challenging for the CFTC to make changes in this area on its own given regulatory interests in coordinating with U.S. banking regulators and international standards.

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[1] Wall Street Journal, *Swaps Rules Due for Overhaul in Bid to Boost Liquidity* (Apr. 26, 2018), available at <https://www.wsj.com/articles/swaps-rules-due-for-overhaul-in-bid-to-boost-liquidity-1524715260>.

[2] J. Christopher Giancarlo, Commissioner, CFTC, 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>.

[3] Rostin Behnam, Commissioner, CFTC, Keynote Address at the FIA 40th Annual Law & Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products (May 3, 2018), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam5?utm_source=govdelivery.

[4] See, e.g., J. Christopher Giancarlo, Commissioner, CFTC, 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>.

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