

CLIENT ALERT

CFTC Chairman Issues Second White Paper on Reforms to Swaps Regulation

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Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps

Picking up the thread from the White Paper he drafted as a minority Commissioner in 2015, Chairman J. Christopher Giancarlo and CFTC Chief Economist Bruce Tuckman issued a further White Paper last week regarding swaps market regulation. In addition to containing a discussion of Chairman Giancarlo's continuing concerns about swaps execution and liquidity, the White Paper also outlines a framework for proposed regulatory reform with respect to central clearing counterparties, swaps reporting, and swap dealer capital, as well as broader exemptions for end-users, particularly with respect to clearing and margin requirements.

Chairman Giancarlo told reporters that he intends to support a proposed rule on swap execution this year, but he would not commit to a timeline with respect to other rulemakings, many of which may be challenging to implement in the near term in light of the need to coordinate with other agencies and international regulators, including on issues such as capital and margin.

Trailblazing is not new to Chairman Giancarlo. Whether advocating for technological innovation or a new methodology for measuring the size of the swaps market, Chairman Giancarlo has consistently said that he supports the core tenets of Dodd-Frank while at the same time suggesting significant changes to the regulatory construct for both markets and users. Rather than pursue incremental changes, at times he has proposed entirely new approaches to implementation, whether

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establishing a blockchain research and development initiative (LabCFTC) or developing a replacement for notional value (Entity-Netted Notionals).

Central Clearing 2.0

As one of the most consequential of the reforms adopted under Title VII of the Dodd-Frank Act, the CFTC's implementation of the clearing mandate has been highly successful in terms of increasing the volume of swaps now cleared by central clearing counterparties ("**CCPs**"). While CCPs in conjunction with the CFTC have made substantial progress in ensuring their soundness, including by implementing credible recovery plans that will allow them to remain viable without government assistance under extreme scenarios, the White Paper suggests that continued vigilance and improvement are essential.

Additional Risk Mitigating Measures

A key consideration going forward is to ensure that newly enlarged CCPs are sound under extreme scenarios, particularly regarding default risks. To that end, the White Paper suggests that a new generation of methodologies should be developed to evaluate the possibilities of near simultaneous defaults, including an analysis of "network relationships that might spread defaults across the system." In addition, the White Paper argues for continued thought and scrutiny regarding right-sizing margin charges for CCP liquidation costs (*i.e.*, the costs of replacing defaulted positions to maintain a matched book) in the event of a clearing member default. The ability to quantify these replacement costs also should be considered when approving new products.

Numerous risk mitigation measures already are required, including maintaining prefunded resources such as initial and variation margin and guaranty funds, among other resources. However, in the event of an extensive crisis, a CCP may not be able to access these resources if they are held in a bank affected by the crisis. Therefore, the rules currently give certain CCPs the right to deposit funds with the Board of Governors of the Federal Reserve. However, the White Paper suggests that this may lead to more concentration risk among CCPs as smaller CCPs do not receive the same benefit, thus creating barriers to entry. Moreover, these same "systemically important" CCPs also receive protections for margin invested in securities. The White Paper points out that as the CFTC continues to review CCP soundness, it should consider whether these protections should be extended to smaller CCPs and potential entrants.

Recovery Measures

Another challenge to policymakers going forward is to increase the transparency and predictability of recovery plans, which are required to describe how a CCP would allocate losses and restore its matched book and financial resources in the case of an extreme scenario. As noted in the White Paper, CCPs need to have recovery plans that are transparent and credible in terms of maintaining their viability without government assistance. The White Paper describes one approach that has gained traction among some CCPs, which is to limit margin payouts that CCPs must make when a

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position has gained in value by applying a pro rata haircut to such payables to the point that they never exceed available resources (*i.e.*, gains-based haircuts). However, this does not protect the CCP from member defaults. To address this additional concern, where a CCP does not have the resources to replace defaulted positions to ensure a matched book, some CCPs take the approach of “tearing up” certain offsetting, non-defaulted positions pursuant to a pre-stated formula until its book is matched again. However, the White Paper points out that both of these measures (gains-based haircuts and tear-ups) also could increase risks to individual market participants and members. Consequently, the White Paper suggests that recovery plans should be as transparent and predictable as possible in order to allow firms to adequately quantify and manage these risks.

CCP Resolution

Finally, in the event that a CCP recovery plan fails, regulators need to consider the challenges related to governmental resolutions, including the need for transparency. The White Paper takes the view that Title II of Dodd-Frank provides for orderly resolution of a CCP if authorities decide to intervene. In such a case, the orderly liquidation fund (“**OLF**”), although limited, could be made available to help ensure continuation of clearing services. However, the White Paper observes that the default of several large financial institutions that had been CCP clearing members most likely would be accompanied by systemic problems that are more pressing than restoring derivatives clearing services. The White Paper therefore calls for close coordination between the FDIC and the CFTC in resolution planning for CCPs.

Swaps Reporting 2.0

Ten years after the financial crisis, regulators still do not have a clear sense of the risks posed by swaps. This is in part due to the fact that initial implementation of the swaps reporting mandate was flawed, requiring too much information to be reported too quickly and with unclear data elements. The CFTC also is examining opportunities to utilize emerging digital technologies to make swaps data more accurate and to provide the regulator with automatic and near real-time access to information, a priority frequently expressed by Chairman Giancarlo.

Swaps reporting 2.0, as outlined in the White Paper, calls for the CFTC to both revamp and streamline the reporting rules and better leverage technology, including by:

- ***Decreasing the amount of, and more clearly defining, the swap data required to be reported.*** This could include streamlining the data elements and providing clear guidelines on acceptable swap data messages.
- ***Providing more time to submit reports to swap data repositories (“SDRs”).*** The CFTC should consider a T+1 time frame to report swap data to an SDR, a change that also would align with foreign regulatory regimes.

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- **Requiring additional verification of data.** At present, the SDR must verify the accuracy of swap data with both counterparties to the swap. Among the alternatives considered in the White Paper is a proposal to require both counterparties to a swap to review and affirmatively verify data with the SDR.
- **Establishing a uniform set of swap data that SDRs must validate upon receipt.** The White Paper envisions the CFTC establishing a “unified set of validations” for swap data similar to the validations for swap data reported in Europe. Under this framework, if the swap data were to fail the validation, an SDR’s system would require the reporting counterparties to resubmit the data.
- **Developing a pilot program to study how best to mask the real-time reporting of large swap transactions (swap block trades).** The pilot program would study the effects of varying cap sizes, block sizes and time delays across trading venues and asset classes in part to address concerns that the current level of transparency introduces trading risk by not taking into account the liquidity profiles of specific swaps and thereby harms liquidity.
- **Encouraging innovation in the use of new technology to support swap data reporting.** The White Paper highlights the potential benefits of reporting swap data via distributed ledger technology (“DLT”), while also noting that regulatory use of these technologies likely will follow industry adoption. The hope is that DLT could provide “regulator nodes” on distributed ledgers, opening the door for near real-time oversight of the swaps markets by allowing the Commission to “be updated on new or amended swap transactions as they happen . . .”. The White Paper cautions, however, that the CFTC’s regulatory requirements should remain “technology neutral” and prioritize security of systems and data.

Mandatory Trade Execution 2.0

The White Paper argues that the current swap execution facility (“SEF”) rules “have stunted swaps trading on SEFs . . . by limiting the execution methods for swaps [that are subject to the mandatory execution requirement].” At present, swaps subject to mandatory trade execution must be executed through a central limit order book, or a request for quote disseminated to at least three market participants. The White Paper makes the case that to promote liquidity, SEFs should have the flexibility to provide for swap execution through “any means of interstate commerce” and that rules enacted for the highly liquid futures markets are the wrong model for swaps.

To coincide with the expanded methods for trade execution on SEFs, the White Paper also suggests that the CFTC should make the “made available to trade” (“MAT”) requirement synonymous with the mandatory clearing requirement as opposed to the current regime whereby designated contract markets and SEFs must separately make a MAT determination subsequent to any CFTC clearing mandate. Until a MAT determination is made, there is no mandatory

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trade execution requirement. These changes would significantly increase the number of swaps executed on SEFs and designated contract markets.

Swap Dealer Capital 2.0

The CFTC has yet to finalize a capital rule for swap dealers. While swap dealers that are banks are subject to a bank capital regime, the White Paper takes the view that the current bank capital requirements overstate the risks posed by swaps. This is in part due to a failure to recognize offsetting swaps positions or sufficiently account for posted margin. Rather than create further complexity in the rules to address these problems, the White Paper recommends that regulators find a way to rely more heavily on the internal models used by banks and their affiliates.

End User Clearing Exception and Uncleared Swaps Margin 2.0

Congress provided various exemptions for commercial end-users of swaps in Title VII of Dodd-Frank. Among them are an exception from mandatory clearing and an exemption from posting or collecting margin. However, the White Paper posits that more end-users of swaps should be eligible for these exceptions and the rules should be less prescriptive. To that end, the CFTC should more narrowly tailor the clearing and margin requirements with a focus on managing systemic risk, including by:

- ***Codifying relief that makes small bank holding companies eligible for the end-user clearing exception.*** The CFTC should codify no-action relief that allows bank holding companies and savings and loan holding companies with consolidated assets that total no more than \$10 billion to rely upon the end-user clearing exception.
- ***Narrowing the definition of “financial entity” in order to expand the types of entities eligible for the end-user clearing exception.*** The CFTC should consider narrowing the definition of “financial entity” in CEA Section 2(h)(7) to clarify and provide relief for a variety of end-users, including treasury affiliates and certain types of special purpose vehicles, among others.
- ***Limiting the impact of the margin rules on small financial end-users.*** The CFTC’s current margin rules require swap dealers to collect and post variation margin for uncleared swaps with all financial end-users regardless of material swaps exposure. The White Paper recommends that swap dealers not be required to collect or post either initial or variation margin from financial end-users that do not have material swaps exposure. In addition, the White Paper contemplates alternatives to the calculation of material swaps exposure, moving away from notional amounts and toward a more risk-based measure, a concept advanced by Chairman Giancarlo earlier this year in a paper on Entity-Netted Notionals (ENNs).

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- **Right-sizing the amount of margin that swap dealers must collect to reflect the risk posed to the swap dealer.** The White Paper contends that the level of margin required to be collected for an uncleared swap should be less prescriptive. The rule should focus on desired outcomes and leave more of the methodology development to industry participants.

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