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CFTC CHAIRMAN AND CHIEF ECONOMIST CO-AUTHOR "SWAPS REG REFORM 2.0"

To Our Clients and Friends:

On April 26, 2018, Commodity Futures Trading Commission ("CFTC") Chairman J. Christopher Giancarlo and the CFTC's Chief Economist Bruce Tuckman released a co-authored white paper titled *Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps* ("White Paper"),^[1] which analyzes and assesses the CFTC's current implementation of the swaps reforms promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").^[2] The White Paper focuses on the following five specific areas of Dodd-Frank swaps reform: clearing and central counterparties ("CCPs"); swaps data reporting; swaps execution rules; swap dealer capital requirements; and the end-user exception. The paper's title is intended to draw an analogy between the need to further refine the CFTC's swaps regulatory reform under Dodd-Frank and the process undertaken by technology companies when updating or upgrading their software applications. Indeed, the authors suggest that the CFTC—like a technology company—needs to assess where its Dodd-Frank swaps regulations are working, where those regulations require "updates" and where they require an upgrade or a complete overhaul.

As part of its analysis and assessment, the White Paper primarily cites to academic research and market activity in reaching certain conclusions regarding the progress made to date and areas for improvement in the CFTC's implementation of Dodd-Frank swaps reform. The authors also cite to the CFTC's four years of regulatory experience in implementing Dodd-Frank swaps reform in the United States as the basis upon which they make certain recommendations "to recognize success, address flaws, recalibrate imprecision and optimize measures. . . ."^[3]

Although the White Paper is comprehensive in its scope, it is noteworthy what the paper does not cover. For instance, while the White Paper includes the authors' recommendations for further changes to the CFTC's swaps regulations and guidance, the paper does not propose detailed or prescriptive modifications to specific CFTC rules. Thus, the paper describes at a high level what the authors envision would result in regulations that are more "economy-focused" and "what's in the best interest of the markets."^[4]

Additionally, the authors make clear that the White Paper does not express the views of the full commission. Interestingly, however, the White Paper does include significant input from CFTC senior staff across all operating divisions (*i.e.*, the directors of the CFTC's Division of Market Oversight, the Division of Swap Dealer and Intermediary Oversight, and the Division of Clearing and Risk).

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Further, the White Paper does not discuss other important Dodd-Frank swaps reform topics such as position limits, the CFTC's swap dealer *de minimis* threshold, the bounds of the CFTC's cross border authority or how best to harmonize the CFTC's swaps ruleset with the security-based swaps ruleset of its sister agency, the Securities and Exchange Commission.

Lastly, the White Paper does not outline the timetable for any proposed changes to the CFTC's swaps regulations. In unveiling the White Paper at an industry conference, Chairman Giancarlo noted that the CFTC will likely begin issuing proposals in the areas of trading and swaps data reporting in the early part of the summer of 2018. Chairman Giancarlo further noted with respect to timing that, "We're not in the wake of a crisis right now — we need to take the time to get this right. We have an ambitious timetable, and we will get this done, but we will do this right."^[5]

In this client alert, we have summarized below some of the key takeaways from each of the five topical areas covered in the White Paper.

Please contact us if you have any questions regarding the White Paper or the CFTC's widely anticipated reforms to its swaps regulations.

Clearing and CCPs

The White Paper notes that swaps clearing is probably the most far-reaching and consequential of the swaps reforms adopted under Title VII of Dodd-Frank. The authors cite data collected by the CFTC in finding that the CFTC's implementation of Dodd-Frank's clearing mandate was highly successful based on the increasing volumes of cleared swaps when compared to before the enactment of Dodd-Frank.^[6]

This section of the White Paper then focuses on the topics of CCP resources to maintain viability under extreme but plausible conditions, CCP recovery when those resources prove insufficient and CCP resolution in the highly unlikely event that a CCP fails. In short, the authors applaud the substantial progress that CCPs and the CFTC have made in order to ensure that CCPs are safe and sound under extreme but plausible scenarios and the work that CCPs have undertaken to develop credible recovery plans to remain viable without government assistance.

In terms of their recommendations to address continuing challenges in this space, the authors assert—without picking winners or losers as between CCPs and their clearing members—that further market-wide discussions are necessary regarding: (1) the development of potential solutions to ensure the liquidity of prefunded resources; (2) the network and systemic effects of defaults; (3) the liquidation costs of defaulted positions; and (4) improving transparency and predictability of CCP recovery plans. Lastly, the authors note that the CFTC must continue to coordinate with the Federal Deposit Insurance Corporation ("FDIC") in formulating resolution plans, which would guide the authority vested in the FDIC under Dodd-Frank to intervene upon the highly unlikely event that a CCP fails.

Swaps Data Reporting

In the section of the White Paper covering swaps data reporting, the authors note that, while the state of data reporting has improved considerably, the CFTC's current swaps reporting regime is "suboptimal"

and "imperfect." They cite the lack of uniform data standards and nomenclature as the biggest problems with the regime. Another cited problem is the fact that the CFTC has not provided sufficient technical specifications to swap data repositories ("SDRs") in collecting data from reporting parties.

The authors then discuss a number of steps that the CFTC has taken within the last few years to improve the effectiveness of its swaps reporting regime, including the CFTC's cooperation with the global regulatory community, SDRs and reporting counterparties to harmonize uniform data standards, nomenclature and technical guidance. The paper also mentions the work that CFTC staff has begun as outlined in the CFTC's *2017 Roadmap to Achieve High Quality Swaps Data* ("Roadmap").^[7] Through the Roadmap consultation process, CFTC staff has heard from a wide range of market participants and interested parties. Under consideration in the Roadmap are changes to the CFTC's reporting rules with the goal of making available to the CFTC and to the public more complete, more accurate and higher quality data.

Finally, in this section, the authors urge the CFTC to ensure that its swaps reporting reforms will remain technologically neutral in order to allow for technological advancement (*e.g.*, through the use of distributed ledger technology) to make reporting systems more reliable, more automated and less expensive. They also urge CFTC staff and market participants to continue to collaborate in order to recalibrate the trade data reporting regime so that it is specific, accurate, and useful enough to: (1) capture systemic risk, market abuse and market manipulation; (2) harmonize with globally accepted risk data fields; and (3) achieve transparency while promoting healthy trading liquidity.

Swaps Execution Rules

In the section covering swaps execution, the authors repeat many of the same concerns and arguments made by Chairman Giancarlo in his 2015 White Paper on swap trading reforms, which was titled *Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank, White Paper*.^[8] Essentially, they assert that Congress did not mandate that swap execution facilities ("SEFs") utilize any particular method of trading and execution. In its final swaps execution rules, however, the CFTC determined that swaps which are "made available to trade" should be subject to the CFTC's mandatory trade execution requirement and must be traded through specified execution protocols (*i.e.*, an order book or a request-for-quote system to three). The authors cite to comprehensive industry research in noting that the CFTC's current swaps execution requirements have stunted swaps trading in the United States, fragmented global trading liquidity, increased market liquidity risk, restricted technological innovation and incentivized a significant amount of price discovery and liquidity to take place off-exchange.

To correct these ills, the authors recommend that the CFTC eliminate the requirement that SEFs maintain an order book and permit SEFs to offer any means of interstate commerce for the trading or execution of swaps subject to the CFTC's mandatory trade execution requirement. Additionally, they argue that the CFTC also should expand the category of swaps subject to the trading mandate to include all swaps that are subject to the CFTC's clearing mandate, unless no SEF or designated contract market lists the swap for trading. Finally, they suggest that the CFTC's regulatory focus should be on enhancing the

professional conduct of swaps execution through licensure, testing and the adoption of professional conduct principles.

Swap Dealer Capital

In the section covering swap dealer capital, the authors note that while current bank capital rules are extremely relevant to the swaps dealing business and the efficiency of swap markets, there are aspects of the current regime that result in an unintended bias against risk taken through swaps markets. To correct this bias, the White Paper argues that bank capital rules need to allow firms to rely on internal models instead of a standardized approach. The paper also argues that the current standardized approach and industry-developed models inappropriately rely on swap notional amounts to measure risk.[9]

The authors do not offer one specific recommended approach to correct these concerns. Instead, the paper offers a couple of remedial approaches. One approach suggested by the authors to correct these concerns is for regulators to continue to refine—and by necessity complicate—the standardized models imposed on market participants. Another suggested approach is for regulators to improve their capabilities with respect to approving and monitoring the use of bank internal models.

End-User Exception

In the last section of the White Paper, the authors assert that Congress intended a robust end-user exception from Dodd-Frank clearing and margin requirements for entities that are unlikely sources of systemic risk. They further assert that there are a number of entities that currently fall within the Dodd-Frank definition of "financial entity" (and thus are ineligible to elect an exception from those requirements) but should not be captured under the definition because those entities are not sources of systemic risk. Specifically, the paper identifies bank holding companies, savings and loan holding companies and certain relatively small financial institutions as being broadly and unnecessarily captured under the definition.

To reduce the burdens on these categories of end-users, the authors offer a few recommendations. First, the authors recommend that the CFTC codify into regulation relief for bank holding companies and savings and loan holding companies that is currently provided in CFTC staff no-action relief.[10]

Second, the authors recommend that the CFTC exempt certain small financial institutions including pension funds and small insurance companies from clearing and margin requirements through a "material swaps exposure" test, which is similar to the test set forth in the CFTC's final uncleared margin rules. Related to their second recommendation, the authors further assert that the CFTC and prudential regulators should consider exempting small financial end-users from uncleared margin requirements by tweaking the material swaps exposure thresholds to address real risk as opposed to risk based on swap notional amounts. Interestingly, the authors cite to studies suggesting that pension funds and insurance companies should not broadly be excluded from the definition because larger entities might still pose significant risks.

Finally, the authors argue that the CFTC should amend the calculation of initial margin for uncleared swaps in the CFTC's uncleared margin rules so that those rules do not promote a bias against the trading

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of uncleared swaps. On this point, the authors argue that Congress did not intend for the CFTC's and prudential regulators' uncleared margin rules to favor cleared products.

[1] J. Christopher Giancarlo and Bruce Tuckman, *Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps* (Apr. 26, 2018), available at https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376, Pub. Law 111-203 (July 21, 2010), as amended.

[3] White Paper at p.i.

[4] CFTC Press Release, No. 7719-18, *CFTC Chairman Unveils Reg Reform 2.0 Agenda* (Apr. 26, 2018), available at <https://www.cftc.gov/PressRoom/PressReleases/7719-18>.

[5] *Id.*

[6] See White Paper, p.7 ("According to data collected by the CFTC on U.S. reporting entities, about 85% of both new interest rate swaps and new credit default swaps were cleared in 2017. Precise data as far back as 2010 are not available, but the Bank for International Settlements (BIS) estimated minimum global clearing rates at that time of about 40% for interest rate swaps and 8% for credit default swaps.").

[7] Staff Advisory, Division of Market Oversight, *Roadmap to Achieve High Quality Swaps Data, U.S. Commodity Futures Trading Commission*, July 10, 2017, available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/dmo_swapdataplan071017.pdf.

[8] J. Christopher Giancarlo, *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>.

[9] The CFTC's Chief Economist and others have published a paper proposing an alternative approach to measuring swaps risk. See Richard Haynes, John Roberts, Rajiv Sharma and Bruce Tuckman, *Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets* (Jan. 2018), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@economicanalysis/documents/file/oce_enns0118.pdf.

[10] See CFTC Letter 16-01 (Jan. 8, 2016).

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The following Gibson Dunn lawyers assisted in preparing this client update: Carl Kennedy and Jeffrey Steiner.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or any of the following:

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