

# Reform, Not Repeal, Likely for US Swaps Regulations

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Swaps transactions, virtually unregulated before the 2008 financial crisis, are regulated in the U.S. under Title VII of the Dodd-Frank Act. Title VII empowers the Commodity Futures Trading Commission (CFTC), for most swaps, and the Securities and Exchange Commission, for the balance of swaps (securities-based swaps), to adopt a comprehensive regulatory framework. Many other G-20 countries have added similar responsibilities for financial regulators given the role swaps played in the financial crisis.

The CFTC now is being run by Acting Chairman J. Christopher Giancarlo. He is the lone Republican CFTC commissioner and recently criticized many, but not all, of the Dodd-Frank swap regulations adopted in recent years. As a result, rules governing CFTC swaps — both those that have been adopted and those still pending — are expected to get something of a fresh look. Renewed scrutiny, however, is expected to lead to perfecting reforms rather than wholesale repeal in many areas, including the four core elements of the Dodd-Frank-authorized swaps regulatory framework: reporting, trading, clearing and cross-border.

## Reporting

Dodd-Frank requires all swaps to be reported to entities called swap data repositories (SDRs). Two types of reports are called for: real-time reports and regulatory reports. Real-time reports are filed with the SDRs after execution of the transactions, as soon as technologically practicable and without disclosing the parties to the trade. These reports are designed to be public, providing important market and pricing information to market participants. Their goal is to enhance price transparency for a market that would otherwise be largely opaque. In contrast, regulatory reports are filed with SDRs on a private, confidential basis and are designed to provide granular detail about swaps transactions and the parties to those swaps. Regulatory reports are a monitoring device that allows regulators to become familiar with every swaps market participant's risk exposures in order to assess whether a party presents credit or systemic risk that requires regulatory attention.

Despite best intentions by regulators and market participants, the success of the standardized reporting regime has been uneven — not surprising, given the nonstandardized, tailored nature of swaps. While price transparency has improved and regulators have much more information available to them on the risk exposures of swaps market participants, compliance with reporting regimes has been challenging. The CFTC staff itself has put out hundreds of pages of guidance with seemingly constant, iterative updates advising on its compliance expectations. Perfecting the reporting data set has been a priority for the CFTC, and even its Enforcement Division has been enlisted in recent years to bring enforcement actions for reporting violations to ensure that banks, which have the bulk of the reporting duties under the CFTC's rules, have been diligent in their implementation efforts.

Despite these measures, Acting Chairman Giancarlo, who is a leading candidate for permanent chair, said in a December 9, 2016, speech: “[E]ight years after the financial crisis the SDRs still cannot provide regulators with a full and accurate picture of bank counterparty risk in global markets.” Acting Chairman Giancarlo recommends enhanced international regulatory cooperation while harnessing emerging digital technologies and network sciences to improve systems. These steps will be important, but figuring out what data are essential and how best to work with the private sector to get the data to the SDRs will be vital, too. Regulators will need to make sure that banks are not required to report details or transactional quirks just for the sake of reporting.

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## Clearing

Dodd-Frank generally calls for most standardized swaps to be cleared by a derivatives clearing organization (DCO). Like regulatory reporting, the purpose of the clearing mandate is to reduce counterparty credit risk in the swaps markets and systemic risk in the U.S. economy. Statutory exemptions are available for commercial end users who use swaps for hedging purposes.

In Dodd-Frank, Congress prescribed a specific process for the CFTC to determine which swaps should be subject to the clearing mandate. By applying that process, the CFTC implemented the clearing mandate for many standardized swaps, namely credit default swaps with a broad-based group of securities and a variety of interest rate swaps. Acting Chairman Giancarlo has observed that the ability of the CFTC to make new clearing mandate determinations has been complicated by issues related to its trade execution rules that apply to swaps subject to the clearing mandate. Once these issues are resolved, some new liquid, standardized swaps may become subject to the clearing mandate.

While Dodd-Frank added swaps to the menu of financial products that are cleared, Congress also demanded greater CFTC oversight of DCOs to ensure financial integrity. As recent positive stress test results show, DCOs have enhanced their already strong protections. DCOs and the CFTC are likely to build on these results without additional regulatory mandates.

## Trading

Dodd-Frank requires any swap subject to the clearing mandate to be traded and executed either on a new type of regulated trading platform called a swap execution facility (SEF) or on a regulated trading platform on which futures have traditionally traded (a designated contract market, or DCM). A swap that is not required to be executed on a regulated trading platform could continue to be executed either bilaterally or through voice brokers that are not regulated as SEFs.

The trade execution mandate was designed to promote transparency and market liquidity. In contrast to the clearing mandate — and as Acting Chairman Giancarlo noted in his 2015 white paper on SEF rules — Dodd-Frank contemplates no process for, or even issuance of, a determination of which swaps are “made available to trade” (MAT). Rather, the statute simply provides that a swap that is required to be cleared must be traded and executed on an SEF or DCM unless “no board of trade or swap execution facility makes the swap available to trade.”

In a move many have questioned, the CFTC adopted rules over three years ago setting out a process for determining which swaps are MAT and thus subject to the trade execution mandate.

The CFTC may propose to reform or repeal the MAT process under the new administration and to loosen the reins on how trading and execution of swaps on regulated trading platforms must occur. These changes could enable the CFTC to make new clearing mandate determinations for additional types of standardized swaps. The CFTC also may revisit how its rules might better promote the trading of swaps on SEFs between qualified U.S. and non-U.S. persons.

## Cross-Border

Recognizing the potential for regulatory disconnects in applying swaps regulations globally, Dodd-Frank included a provision that U.S. swaps reforms not apply to activities outside the U.S. unless the activities have “a direct and significant connection with activities in, or effect on, commerce of the [United States].” Consistent with this provision and principles of comity, the CFTC’s stated policy has been that compliance with a foreign jurisdiction’s law and regulations can substitute for compliance with many of the CFTC’s swaps regulations if the CFTC determines that the foreign regime’s requirements are comparable to and as comprehensive as CFTC regulations. Other countries also address cross-border regulatory duplication and coordination. For example, in the European Union, a determination must be made that regulations in a non-EU jurisdiction are equivalent to EU requirements.

The Financial Stability Board’s 11th progress report on implementation of swaps regulatory reforms, published in August 2016, found that “[a]uthorities continue to engage bilaterally and in multilateral fora seeking to resolve cross-border issues.” Indeed, 2016 ended with a flurry of cross-border decisions on clearing relief from the CFTC and third-party central counterparty recognition by the EU and the European Securities and Markets Authority. Likewise, during 2016, the U.S., EU, Canada, Japan and other countries began to implement uncleared margin requirements with coordination on many issues, such as the types of collateral permitted, the daily nature of margin and implementation dates.

Even with this kind of cooperation, global market participants and U.S. regulators alike are becoming increasingly concerned that the cross-border harmonization of regulatory schemes is lagging too far behind the adoption and implementation of derivatives regulations. As more such regulations take effect, Acting Chairman Giancarlo has observed that U.S. market participants are being “shunned” as counterparties by non-U.S. traders because their U.S. person status is a “scarlet letter” that triggers CFTC regulation of the transaction. As a result, swaps markets are being divided into two sets of liquidity pools — one with U.S. persons and one without. In the coming year, the CFTC

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and perhaps even Congress can be expected to re-examine how to ensure that transacting with a U.S. person does not automatically subject the transaction and the parties to CFTC jurisdiction. This reassessment of the U.S. cross-border approach will require consideration from non-U.S. regulators regarding whether and how to pull back their jurisdictional parameters in a manner akin to whatever solution the CFTC and Congress may devise. In other words, global cooperation and mutual regulatory respect will still be needed for the global swaps market. How that can be achieved will be a great challenge for the CFTC and Congress as the new administration begins its work.