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CFTC Updates on Virtual Currency Regulation, Alternatives to Libor and Fallout from Brexit

By Mark D. Young, Jonathan Marcus, Theodore M. Kneller and Rachel Kaplan Reicher
Skadden, Arps, Slate, Meagher & Flom LLP

In 2017, Commodity Futures Trading Commission (CFTC) Chairman J. Christopher Giancarlo made clear he will strive to improve, not abolish, many reforms the CFTC adopted to implement the Dodd-Frank Act's mandate for new derivatives regulation, with a particular emphasis on swaps market structure issues. (Giancarlo was confirmed as chairman in August 2017 and previously served as the acting chairman.) In 2018, we may see (1) a rulemaking proposal to amend the rules governing swap execution facilities, with a focus on the rules specifying required swap execution methods; (2) final rules on the long-standing proposal to impose some form of CFTC speculative position limits on physical commodities (agriculture, metals and energy); (3) a new rulemaking proposal for algorithmic trading; and (4) a major judicial decision on the CFTC's price manipulation authority. We also may see the Trump administration fill the two remaining vacancies (one Democratic and one Republican) on the commission, which has not had the full complement of five commissioners since 2014. A full commission may make the agency more comfortable working through major initiatives.

Additionally, there are three significant regulatory developments to watch closely in 2018 as they relate to virtual currency, interest rate benchmarks and Brexit.

Virtual Currency: Regulating Bitcoin

Whether styled as virtual currency, cryptocurrency, bitcoin or ether, this new asset class makes headlines almost every day. (See "Rise of Blockchain and ICOs Brings Regulatory Scrutiny.") Derivatives recently have played a major role in this story, and several U.S. exchanges either are currently offering or plan to offer CFTC-regulated futures or options products based on virtual currency. Under Chairman Giancarlo's leadership, in May 2017, the CFTC created LabCFTC within its general counsel's office to act as the agency expert and information clearinghouse for all things virtual currency. The CFTC's Division of Enforcement has been active in this space since 2015, pursuing cases involving retail fraud and failure to register.

In 2018, we are likely to see even more CFTC engagement. While no federal regulator exercises direct oversight and supervision for the trading markets in virtual currency itself, the CFTC regulates futures and options markets directly and comprehensively. A bitcoin futures contract, for example, would be regulated generally, like all other futures products. But the CFTC would not regulate the actual market in bitcoin any more than it would regulate the actual market in wheat, gold or crude oil where market participants contract for the actual delivery of the commodity. Whether that will

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change remains to be seen. Fundamental questions surrounding the explosion of interest and transactions in virtual currency that market participants need to consider and which federal regulators — and, in some instances, Congress — may need to address include: Is new statutory authority needed or advisable? What role will self-regulatory bodies like futures exchanges and the National Futures Association play? And where does the regulatory authority of the Securities and Exchange Commission start and stop in relation to that of the CFTC?

Libor

The London Interbank Offered Rate (Libor) is perhaps the most ubiquitous interest rate benchmark in the world's financial markets. Traders and commercial enterprises rely on Libor to price a wide range of instruments, from swaps to adjustable-rate mortgages. Libor is referenced by an estimated $350 trillion of outstanding contracts. But two issues have clouded Libor's continued viability. First, following the financial crisis of 2007-08, allegations arose that some traders at certain banks made false Libor submissions, triggering major government investigations and fines. Second, market practice has made Libor less reliant on actual transactions and more reliant on submitting banks' judgment, which concerns many in light of the government investigations.

Federal banking officials and CFTC Chairman Giancarlo have actively supported a Libor phase-out. Regulators in the U.S. and in other countries have created advisory committees, given speeches, evaluated and developed alternative rates for the currencies in which Libor is published, and solicited public comments. Regulators and working groups are developing transition plans to ensure that a move from Libor to alternative rates would be smooth and leave undisturbed the expectations of traders as well as of parties to commercial transactions.

At this point, it is unknown whether Libor will continue to be used as it is today, be replaced entirely by alternative rates or co-exist with them. Bank regulators and Chairman Giancarlo appear to be convinced that Libor must be replaced, and a consensus appears to be forming among the regulators that an overnight financing rate would be a credible and preferable alternative because it would be based on real transactions. Last year, the Alternative Reference Rates Committee (ARRC), a Federal Reserve-sponsored group studying alternative benchmarks, recommended a broad Treasurys repurchase (repo) financing rate — tied to the cost of overnight borrowing collateralized by U.S. Treasury securities — as its preferred U.S. dollar Libor alternative.

The Federal Reserve Board also has announced plans to publish three new reference rates based on overnight repo transactions, including the rate selected by the ARRC (called the Secured Overnight Financing Rate), in the second quarter of 2018. Yet Libor administrators insist that the benchmark's past problems have been rectified. In addition, commercial market participants, including parties to commercial loans and mortgages, recently have expressed concern that transitioning to a new rate may have unintended financial consequences for parties that negotiated their agreements based on Libor. Similarly, the fate of the benchmark will be a significant issue for the financial trading sector in 2018, especially as parties review their derivatives documentation to ensure that a transition from Libor to alternative rates would not result in a windfall for one party. Given the number of derivatives contracts priced by reference to Libor, the CFTC is expected to be in the thick of it.

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Brexit and Derivatives Clearing

In the aftermath of the financial crisis, a worldwide consensus emerged that clearing of derivatives — which removes counterparty credit risk — would reduce risk in the financial system. As a result, many derivatives are now submitted to clearing.

As the European Union and the United Kingdom negotiate the terms of Brexit, one of the most contentious issues has become what to do about central counterparties (CCPs) clearing derivatives. The issue is a complicating factor for Brexit because major sources of clearing in the EU reside in London. The EU could insist that those entities relocate and be subject to regulation by the remaining 27 member states (EU27). It could permit the clearing entities to stay in London but insist that they be subject to EU27 supervision and regulation — a model called third-country regulation. Or it could allow clearing to remain in London and defer to the regulators in the U.K.

In 2017, the answers began to take shape in a form that presents ominous challenges for CCPs in the United States. The EU proposed legislation last year that would set out an elaborate regime for how non-EU CCPs that accept clearing business from EU counterparties would be regulated. Under this proposal, non-EU CCPs — including those in the United States and the U.K. after Brexit — would be subject to EU dictates on everything from corporate structure to vital risk management policies. While for decades U.S. CCPs have been subject to exclusive regulation by the CFTC, those days would be over, and not because the CFTC's regulation has been inadequate. It is widely considered the international gold standard.

Chairman Giancarlo has been vocal about what he views as the EU's attempt to trespass on the agency's turf. The CFTC does not require EU CCPs that clear futures and options for U.S. customers to be subject to CFTC oversight, deferring to the EU to regulate its CCPs. In the past, such rough edges in cross-border regulation have eventually been smoothed over. In 2018, market observers will see whether international comity carries the day or a hotly contested oceanic tug of war sparked by Brexit threatens to destabilize a critical area of financial market systemic risk mitigation.

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