[Securities Regulation Daily Wrap Up, TOP STORY—Giancarlo updates House oversight committee on clearinghouse, cryptocurrency issues, (Jul. 26, 2018)]

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

In an oversight hearing of the House Agriculture Committee, CFTC Chairman J. Christopher Giancarlo gave updates on derivatives issues, including the increasingly precarious status of the existing U.S.-E.U. agreement on regulation of derivatives clearinghouses and the proper role of the CFTC and other agencies in regulating cryptocurrencies and blockchain. Giancarlo also discussed other issues including LIBOR and proposed position limits rules.

Clearinghouse issues. Currently, the European Commission and CFTC have an agreement providing for mutual recognition of derivatives clearinghouse regulatory regimes. However, there is a proposal before the European Parliament that would impose European substantive law on U.S. clearinghouses. This prompted questions from several members, including Committee Chairman Mike Conaway. Giancarlo said that the threatened breakdown of the existing agreement is happening because of Brexit, and it is of great concern because the laws are quite different.

"If their law applies and our law applies, I don't know how we're going to reconcile these two very different approaches," said Giancarlo.

In response to a question from Rep. David Scott (D-Ga) as to what would happen if the existing agreement broke down, Giancarlo explained the probable sequence would be that after the European legislation passed, probably after Brexit, the E.U. would say that the law will apply to U.S. clearinghouses. Then, the probable next step would be that European firms could no longer use the services of U.S. clearinghouses.

Giancarlo said the proposed change is not due to any shortcoming in the U.S. regulatory regime, as U.S. clearinghouses have never had a major failure going back to the start of the clearing regime in the 1930s, including during the financial crisis, when U.S. clearinghouses stood "tall and strong." He added that for the world's fifth largest market to dictate rules for the world's largest market seems a little "outside their lane." Further, cutting off European firms from U.S. clearinghouses would create problems for Europe because some of the most important products, including dollar interest rate futures, only trade on the CME, and European hedge and pension funds need to use those products. Some of these products have no substitutes, he said, noting that trade disputes can add to heated discussions.

On the domestic front, clearinghouses are facing the challenge of explaining why they should not be treated like banks for purposes of "too big to fail" bank capital and wind-down regimes. Giancarlo said that the biggest difference is that the goal for clearinghouses should not be to wind them but to keep them going, and he has spent a lot of time with the FDIC helping them understand their unique nature. Rep. Frank Lucas (R-Okla) said that bank capital requirements should not interfere with clearing, and noted that the CFTC's economist recently published a paper showing that capital requirements, specifically the leverage ratio, is impacting liquidity. Giancarlo said there has been progress on this in conversations with prudential regulators, particularly Federal Reserve Vice Chairman for Supervision Randal Quarles, and that he thinks this is "on their to-do list."

Cryptocurrency and LabCFTC. Several members asked about CFTC jurisdiction over cryptocurrency and expressed concern about duplicative regulation by multiple regulators. Giancarlo explained that the CFTC does not have jurisdiction over the underlying cryptocurrency cash markets, but does have authority over fraud and manipulation.

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Asked by Rep. Stacey Plaskett (D-Va) and Rep. Darren Soto (D-Fla) if the CFTC should be given additional jurisdiction, Giancarlo demurred, saying that the CFTC has not traditionally had jurisdiction over cash markets and has not been a retail regulator, and gaining that jurisdiction would change the agency's orientation. He said there may come a time for federal regulation, but noted that the futures markets were around for many years before being federally regulated, and they policed themselves reasonably well. Also, cryptocurrency is still a relatively small market.

"I think we can allow it to evolve a little bit before we run in with regulation. But we need to stay close to it, and we are," he said. He added that the CFTC has been working with the National Futures Association (NFA) and has taken a number of steps in the area including issuing consumer advisories. Asked by Conaway if the CFTC could demand a "regulator node" on blockchains, Giancarlo said he was not sure if authorizing legislation would be needed. The CFTC does have subpoena authority, but that would probably not be the right way to go.

But to keep up with cryptocurrency developments as well as other areas, the CFTC does need to step up its data analytics abilities and access to new technology, said Giancarlo. In response to a question from Rep. Austin Scott (R-Ga), he said that the agency's innovative technology working group, LabCFTC, has had "well over" 200 meetings with innovators, who run the gamut from startups to large financial service providers. He said that the CFTC faces challenges in obtaining new technology, explaining that currently, if the CFTC goes through the procurement process, by the time the agency obtains new technology in development, it has already launched. He welcomed proposed legislation called the Research & Development Modernization Act, which would allow the CFTC to get around restrictions imposed by the Administrative Procedure Act to obtain new technology.

LIBOR transition. Ranking Member Collin Peterson (D-Minn) said he is very concerned about a delay in an official transition away from the use of the London Interbank Offered Rate (LIBOR) as a reference rate. He noted that LIBOR underpins almost $200 trillion in derivatives, and millions of student loans, credit cards, bank deposits, auto financing agreements, and home mortgages. He asked if a delay in transition could disrupt orderly markets, what would that mean for end users, and what measures should regulators or Congress consider.

Giancarlo responded that the LIBOR transition is a very important matter. Because the overnight funding markets are not widely used the way they were 30 or 40 years ago, LIBOR rates are no longer based on trading activities but on the educated professional judgment of a handful of banks. He said there is widespread governmental support for the shift away from LIBOR, including former CFTC Chairman Tim Massad, Governor Powell of the Fed, the Governor of the Bank of England, and the Chief Executive of the Financial Conduct Authority. Giancarlo commended Commissioner Rostin Behnam for using the CFTC's Market Risk Advisory Committee to flesh out these issues, and said the discussion needs to broaden beyond the Washington–New York corridor into the rest of the country, to make people aware that this change is coming and what it entails.

Position limits. Representative Al Lawson, Jr. (D-Fla) asked, with gas prices rising again, in the interest of preventing price manipulation, where is the CFTC on issuing a position limits rule? Giancarlo said that the agency is making good progress. Although the proposal was put out during the final months of Chairman Massad's term, in meetings with producers and other industry participants, it emerged that hedge exemptions were too narrowly crafted. Giancarlo hopes to put forward a solid proposal by the end of the year.

Representative Rick Crawford (R-Ar) asked if the hedge exemption issue was keeping bona fide hedgers out of the markets, and if so, if that was creating greater volatility. Giancarlo agreed that the hedge exemption issue is overly narrow, noting that farmers can't use hedges they have used for generations. Crawford asked if Giancarlo would support an initiative, possibly jointly with the NFA, to authorize a Series 3a brokerage hedge exemption tailored for end users in the agriculture space. Giancarlo responded that he had not thought about such an initiative but it sounded promising.

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