Securities Regulation Daily Wrap Up, DERIVATIVES—CFTC adopts swaps-related and Volcker Rule amendments, proposes rules on electronic trading, (Jun. 25, 2020)

Securities Regulation Daily Wrap Up

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In addition to adopting several swaps-related final rules, the Commission withdrew the controversial "Regulation Automated Trading" proposal and issued a new proposal in its place.

In a busy open meeting, the CFTC adopted final rules relating to swaps clearing, as well as final rule amendments to Volcker Rule provisions addressing covered funds. The Commission also withdrew a previous proposal on automated trading and introduced a new proposal addressing electronic trading. Finally, the Commission proposed to extend the compliance date for certain margin requirements for smaller swaps entities.

The meeting included staff presentations and was held via conference call due to the COVID-19 (coronavirus) pandemic.

Electronic trading. The Commission took two related actions relating to electronic trading. First, by a 3-2 vote, the Commission withdrew a previous proposal and supplemental proposal called "Regulation Automated Trading" or "Reg AT." The proposal, issued in 2015, and supplemental proposal, issued in 2016, would have imposed rigorous requirements relating to automated trading.

According to Tarbert, Reg AT was overly prescriptive and would have established certain specific controls that would not have kept up as technology evolved. He also believes the proposal suffered from other fatal flaws, including requiring market participants that use algorithmic trading methods to register with the CFTC and make their source code available to the CFTC upon request. In Tarbert's view, it was best to withdraw the proposals altogether and start anew.

The new proposal, "Electronic Trading Risk Principles," broadens the focus from automated trading to all electronic trading, which Tarbert said accounts for 96 percent of all trading overseen by the CFTC. The proposal takes a principles-based approach to prevent, detect, and mitigate market disruptions and system anomalies that can arise during electronic trading due to many causes. As examples of market disruptions, Tarbert cited excessive messages, fat finger orders, or the sudden shut off of order flow from a market maker.

The proposal would establish three Risk Principles:

1. Exchanges must have rules to prevent, detect, and mitigate market disruptions and system anomalies associated with electronic trading. This would include fashioning rules applicable to all traders governing items such as on boarding, systems testing, and messaging policies.
2. Exchanges must have risk controls on all electronic orders to address those same concerns.
3. Exchanges must notify the CFTC of any significant market disruptions and give information on mitigation efforts.

Tarbert explained that implementation of the Risk Principles would be subject to a reasonableness standard, such an exchange would be in compliance if its rules and its risk controls are "reasonably designed" to meet the above objectives. The CFTC would have the ability to monitor compliance by the exchanges and would have avenues to sanction non-compliance.

Commissioner Dan Berkovitz dissented from the withdrawal of the Reg AT proposal, but offered qualified support for the new proposal. According to Berkowitz, Reg AT was a comprehensive approach for addressing automated trading in Commission regulated markets, and the comments received are worth evaluating going forward. In

his view, the new proposal recognizes the need to update the Commission's regulations to keep pace with the speed, interconnection, and automation of modern markets. However, he is not yet convinced and looks forward to public comment on whether the proposal is sufficiently detailed or comprehensive to effectively address those risks.

Commissioner Rostin Behnam also voted against withdrawing the Reg AT proposal, and in addition voted against issuing the new proposal. Behnam believes that the proposal does not minimize the potential for market disruptions and other operational problems that may arise from the automation of order origination, transmission or execution, and create structures to absorb and buffer breakdowns when they occur. He also believes it does not particularly require exchanges to do anything new or differently. This could be confusing for market participants and could set them up for more than they bargained for in the future, said Behnam.

"[W]hen there is a technology failure—and there will be—will the Commission stand by its principles or will it fashion an enforcement action around a black swan event so that everyone walks away bruised, but not harmed?" said Behnam.

Volcker Rule. Prior to the open meeting, the Commission had voted via seriatim to adopt final rule amendments to the Volcker Rule by a 3-2 vote. The proposal, issued by the Commission in January 2020, follows other targeted revisions and specifically addresses covered funds. The proposal was issued jointly as an interagency rule with the CFTC, SEC, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and the Board of Governors of the Federal Reserve System (FRB).

According to Tarbert, the final rule amendments begin to address the over-breadth of the covered funds definition and related requirements. Specifically, the Volcker Rule will now no longer be applied to certain investments including credit funds, venture capital funds, customer facilitation vehicles, and family wealth management vehicles. The amendments also modify several existing exclusions from the prohibition on activities related to private equity and hedge funds for foreign public funds, loan securitizations, and small business investment companies.

Both Berkovitz and Behnam dissented from the final rule adoption. In Berkovitz's view, the new rules allow banks to take greater risks without adequate assessment of those risks, and are not necessary for the banking industry to succeed. Similarly, Behnam believes the amendments erode existing protections against systemic risk.

Inter-affiliate swaps clearing exemption. By a 5-0 vote, the Commission voted to finalize amendments to the CFTC regulation that exempts certain affiliated entities within a corporate group from the swap clearing requirement. The amendments were proposed in December 2019.

As Tarbert explained, just as the government does not regulate loans between family members, transactions between affiliated entities in a corporate family are subject to less oversight than arms-length transactions with external entities. However, in implementing swaps clearing requirements under the Dodd-Frank Act, anti-evasionary measures were adopted to prevent entities from using inter-affiliate swaps to shuffle transactions over to jurisdictions that had not yet adopted comparable clearing requirements. To allow time for foreign clearing regimes to be deemed comparable, CFTC staff issued no-action relief, creating temporary alternative compliance frameworks that over 70 eligible affiliate counterparties located outside the U.S. have relied on.

However, as Berkovitz explained, some compatibility determinations have not occurred as anticipated. In order to provide legal certainty and make the anti-evasionary condition workable for international corporate groups in the absence of foreign clearing regimes determined to be comparable to U.S. requirements, the Commission adopted final rule amendments to make permanent the temporary alternative compliance frameworks.

"By codifying this relief, we are providing the swaps market with clarity, certainty, and transparency—consistent with the CFTC's mission, core values, and strategic objectives," said Tarbert.

Post-trade name give-up. By another 5-0 vote, the Commission voted to adopt final rules restricting the practice of post-trade name give-up. The rules were introduced in a proposal in December 2019, which received support from key stakeholders.

As several commissioners explained in a joint statement, "name give-up" is an industry practice from a time when most swaps were arranged directly between counterparties rather than through a regulated exchange. Because these over-the-counter swaps were not centrally cleared, market participants needed to know their counterparty's identity in order to manage to credit risk. As a result, trades were not anonymous.

As many swap transactions have moved onto regulated exchanges following the Dodd-Frank Act and central clearing has addressed the credit risk issue, many have questioned whether there is still a need for post-trade name give-up for cleared swaps. Some have criticized the practice as anticompetitive, an obstacle to broad and diverse participation on swap execution facilities (SEFs), and potentially inconsistent with numerous provisions of the Commodity Exchange Act (CEA) and Commission regulations.

The final rule prohibits name give-up for swaps that are executed anonymously and intended to be cleared. It does not apply to swaps that are not intended to be executed anonymously, such as trades done via a name-disclosed request for quote. The rule also includes a limited exception for "package transactions" with at least one component that is an uncleared swap or a non-swap instrument. The rule includes a phased implementation schedule.

According to the joint statement, the commissioners believe that by protecting trading anonymity where it is possible to do so, the rule promotes swaps trading on SEFs and fair competition among market participants. The commissioners observed that the name give-up issue "can be a bit of a lightning rod" and said CFTC staff stands ready to work with market participants and operators to resolve any issues.

Phase 6 margin requirements. Finally, the Commission voted 5-0 to propose the extension of the compliance date for "Phase 6" margin requirements by one year to September 1, 2022. Currently, smaller swaps entities are scheduled to come into compliance with certain margin requirements by September 1, 2021. Berkovitz noted that this would be the second extension for these entities, and is not convinced that another extension is really needed, given that entities have had years to prepare. However, given hardships imposed by the COVID-19 pandemic and the fact that other jurisdictions have also slowed compliance, Berkovitz supported issuance of the proposal.

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