SPEECHES & TESTIMONY

Keynote Address of Chairman J. Christopher Giancarlo Before the ABA Business Law Section, Derivatives & Futures Law Committee Winter Meeting

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Introduction

Thank you for the opportunity to speak to you.

I am sorry that I am not with you in person. I had every intention to join you today, as did agency staff who were invited to speak on panels. I know there are so many fine colleagues and truly distinguished members of the derivatives bar gathered together. I hope that you all enjoy this year's program.

Let me note that ABA has kindly agreed to post the full text of these remarks online with the other Conference materials. Of course, they will also be posted on the CFTC's website in due course.

Agency Shutdown

As you know, the CFTC is in shutdown mode along with much of the Federal Government. That means that all agency work that is not essential to preservation of life and property has ceased. It means a pause in the agency's policy agenda, including work on SEF reform, Project KISS, position limits, swap dealer *de minimis*, CFTC/SEC rule harmonization, LabCFTC initiatives, increasing regulatory deference for overseas jurisdictions and participation in international work streams and standard setting activities. It means suspension of ongoing agency examinations of clearinghouses and exchanges. It means a halt to routine enforcement actions.

Fortunately, the agency is able to continue to perform essential market-critical functions. That means that a small team of CFTC staff continue to monitor derivatives markets, ensure essential enforcement activities are carried out, and evaluate market activity across futures and swaps to identify potential impact on the clearing system. Personnel performing these excepted functions remain in communication with key market participants and self-regulatory organizations, which continue their own market and risk surveillance activities. You might say that the CFTC is in “silent running” mode in which many activities are suspended, while the agency engages in informed but passive monitoring of market developments.

During this time, most CFTC employees have been furloughed. Undoubtedly, the situation is a source of uncertainty, anxiety and even hardship for many of our team and their families. Along with my fellow Commissioners, I am most sympathetic to their personal situations and concerned for their welfare. Let us hope that the shutdown will be resolved as soon as possible for their sakes and the sake of the overall mission of the agency.

Meanwhile, CFTC Commissioners are exempt from furlough, though our paychecks are suspended along with the agency payroll. In that respect, we share in understanding some of the pain of many of our agency colleagues. Still, my fellow Commissioners and I remain engaged on important policy issues. I believe you may be hearing from several of us during your conference.

I want to take this opportunity to discuss with you two current policy initiatives. First, the cross-border application of CFTC swaps regulations and, second, our recently proposed revisions to the existing SEF rules.

Cross-Border Deference

Four months ago, I released a White Paper on cross-border swaps regulation[1] that proposed updating the agency’s current cross-border application of its swaps regime with a rule based framework based on regulatory deference to third country regulatory jurisdictions that have adopted the G-20 swaps reforms.

I want to lay out for you the context for the White Paper before discussing next steps in cross-border policy development.

As you know, in the late 20th Century, regional and national markets for financial products expanded into global markets. The era produced a new term, "globalization," denoting increasing interdependence of economic and cultural activities. Many observe that the era of "globalization" led to rising employment and standards of living for over a generation.

During that period of time, swaps grew in importance and maturity. Trading of swaps was (and remains) conducted exclusively by institutional counterparties in the world's major financial centers. While local financial regulation applied to these professional markets, the primary trading and contractual protocol for swaps came from the private sector, the International Swaps and Derivatives Association (ISDA). The ISDA protocol provided a singular global standard that facilitated active trading across borders. Deep pools of swaps trading liquidity emerged in major regional centers based around key global currencies. Access to those regional liquidity pools was quite open and uniform based on adherence to the universal ISDA protocol.

Then came the financial crisis of 2008. In response, the G-20 decided a year later in Pittsburgh to implement a series of reforms to global swaps markets. Those reforms were drawn from emerging industry best practices and included increased swaps central clearing, trade reporting and trade execution on regulated platforms along with swap dealer registration and increased capital and margin. These G-20 reforms would be implemented appropriately at the G-20 nation state level in a fashion that was "consistent," though not identical.

The United States moved first to enact the Pittsburgh accords in the Dodd-Frank Act in 2010, and the CFTC moved commendably to implement most of the swaps reforms by the end of 2014.

Five years later, most of the CFTC's reforms appear to be working well, especially the implementation of the swaps clearing mandate. Other CFTC reforms, in my opinion, are less than optimal, namely the swaps trading mandate and its application outside of the United States.

As you know, I remain a critic of the mismatch between the CFTC's swaps trading regulatory framework and the distinct liquidity and trading dynamics of the global swaps markets.[2] This mismatch – and the application of this framework worldwide – has caused numerous harms, foremost of which is reluctance of global market participants to transact with entities subject to CFTC swaps regulation.

Traditionally, users of swaps products chose to do business with global financial institutions based on factors such as quality and breadth of service, product expertise, financial resources and professional relationship. Under the CFTC's current framework, those criteria are secondary to the question of the institution's regulatory profile. Non-U.S. market participants avoid financial firms bearing the scarlet letters of "U.S. person" in certain swaps products to steer clear of the CFTC's problematic regulations. As a result, non-U.S. market participants' efforts to escape the CFTC's flawed swaps trading rules have fragmented global swaps trading and driven global capital into separate liquidity pools based on nothing more commercially important than entity identity.

Since the start of the CFTC's SEF regime in October 2013 and accelerating with mandatory SEF trading in February 2014, global swaps markets have divided into separate trading and liquidity pools: those in which U.S. persons participate and those in which U.S. persons are shunned. Liquidity has been fractured between an on-SEF, U.S. person market on one side and an off-SEF, non-U.S. person market on the other.[3]

Such fragmentation exacerbates the already inherent challenge in swaps trading – adequate liquidity – and increases market fragility as a result. Fragmentation leads to smaller, disconnected liquidity pools and less efficient and more volatile pricing. Divided markets are more brittle, with shallower liquidity, posing a risk of failure in times of economic stress or crisis. Fragmentation increases firms' operational risks as they structure themselves to avoid the rules of one jurisdiction and be subject to the rules of another while managing multiple liquidity pools in different jurisdictions (*e.g.,* through different affiliates). As structural complexity increases, operational efficiency is reduced.

Fragmentation of global financial markets may be likened to habitat fragmentation in the natural world, in which large, continuous biological habitats are divided into a greater number of smaller eco-systems, isolated from each other by a matrix of dissimilar habitats, leading inexorably to broad ecosystem decay.[4]

In a similar way, trading market fragmentation, whether caused by entity based regulation or the implementation of other post crisis reforms, may harm market liquidity and market safety and soundness, increasing the systemic risk that G-20 market reform was predicated on reducing. Amidst the current tide of de-globalization and slowing world economic growth, market regulators should not ignore the potential systemic risk inherent in market fragmentation.

That is why we worked so hard in 2017 to reduce market fragmentation by achieving a landmark comparability determination with the European Commission. It is also why our recent White Paper proposes replacing the CFTC's current "entity based" approach to cross-border application of its swaps regime with a "territorial" framework based on regulatory deference to third country regulatory jurisdictions that have adopted the G-20 swaps reforms. It advocates moving away from numerous separate "entity" based liquidity pools in each of the world's major trading jurisdictions. Instead, it encourages the development of unified "territorial"- based trading liquidity pools under the jurisdiction of the competent local regulator that applies the G20 swaps reforms. The White Paper contends that the antidote to global trading market fragmentation is a broad regulatory program of deference to third country regulatory jurisdictions to achieve in each global trading center "one market, one regulator, one set of equivalent swaps reforms."

Of course, the White Paper did not purport to specifically address every cross-border issue, but to lay out a high-level framework for approaching the matter. It sought to offer enough detail to give readers a good sense of direction, yet acknowledges that details and substance must be worked out properly through the agency rulemaking process.

It is clear that the White Paper did not get everything right. Its approach to ANE transactions,[5] for example, may need further thought and refinement. Yet, that was exactly the purpose of the White Paper - to serve as a conceptual framework to generate more focused discussion so that resulting rule proposals would be closer to the mark when brought before the Commission and the public.

Still, I believe that the White Paper got the big things right. Since its release, I have had extensive conversations with other regulators and most major participants in swaps markets here and abroad. These conversations have confirmed to me that the CFTC's current cross-border approach of applying its regulations to each and every overseas swap transaction by a U.S. Person whether or not such activity actually has a "direct and significant" impact on the United States is a flawed and over-expansive assertion of its Dodd-Frank Title VII jurisdiction. For an agency with perennially restrained funding, the overreach of CFTC jurisdiction is untenable. Worse, the impact of this overreach has contributed to fragmenting global markets into a complex series of ever more shallow pools of trading liquidity that, in a market crisis, may present significant global systemic risk.

Therefore, I believe the CFTC must move forward to replace its over expansive assertion of regulatory jurisdiction with an approach based on regulatory deference to third country regulatory jurisdictions that have adopted the G-20 swaps reforms.

That is why, once the government shutdown ends, I intend to direct CFTC staff to prepare as soon as possible to put through the Administrative Procedure Act process various new cross-border rule proposals. They will address a range of cross-border issues in swaps reform – from the registration and regulation of swaps dealers and major swaps participants to the registration of non-U.S. swaps CCPs and swaps trading venues. The intention is to replace the cross-border guidance issued by the CFTC in 2013 and the cross-border rules proposed in 2016, as well as address certain positions taken in CFTC staff advisories and no action letters.

The CFTC must adopt a new cross-border framework that is risk-based and offers deference to comparable non-U.S. regulations. It is my sincere hope that my fellow Commissioners and regulators of the world's swaps markets will support us on this path. I know it is the right direction forward.

SEF Reform

Let me now turn to SEF reform.

As you know, last November the CFTC adopted a proposed rule on Amendments to Regulations on Swap Execution Facilities and the Trade Execution Requirement (Amendments) and a Request for Comment (RFC) regarding the Practice of "Post-Trade Name Give-Up."[6]

Earlier this month, I conducted a series of meetings in New York City to discuss the proposed Amendments and the RFC. These meetings were originally set up to be led by the SEF rule writing team. Due to the government shutdown the team could not attend. I faced a choice of cancelling the meetings or going solo. I decided to go forward.

Over the course of a week, I met with a dozen and a half major participants in global swaps markets, including all of the leading SEF platforms, major bank and non-bank swaps dealers and market makers, and major asset managers and other buy-side institutions. Everyone I met with expressed a desire to engage on the SEF proposal in good faith and in a positive spirt. All expressed appreciation for undertaking to revise the current framework. Almost all agreed that the current framework is flawed, clunky and would benefit from substantial revision. Many agreed that the current framework, as it is built upon various no action relief, staff guidance and temporary regulatory forbearance, is unsustainable as a long term proposition.

There was also broad acceptance of the benefit of making SEF execution methods more flexible and SEFs themselves more attractive and less restrictive for swaps market participants. There was strong interest in replacing existing no-action relief and staff guidance with final rule making and easing the most burdensome and unworkable aspects of SEF compliance. There was clear support for broker proficiency exams. And, there was considerable interest in bringing more cleared swaps products into scope, if done gradually with broad market consensus.

That does not mean the proposed Amendments were without constructive criticism. Almost all expressed concern with the process and timing of bringing new products into scope. Many were also concerned with the proposed restrictions on off-SEF, pre-trade communications. And there was broad concern with how the proposal dovetails with reforming our current cross-border rule implementation. Some raised concerns that the proposal overly simplified revisions to the standards for “impartial access.” And a number of firms discussed various technical standards and provisions like error trade policy and financial resources.

Let me address a few of these concerns now.

In making the “made available to trade (MATT)” trading mandate co-incident with the swap clearing mandate, the intention was to increase the amount of swaps products traded on SEFs. Concerns were expressed that the proposal may inadvertently have created the opportunity for a single SEF to force market-wide SEF execution by quickly listing cleared swaps products. This was not the proposal’s intention. I believe that bringing swaps subject to the clearing mandate into scope of the trading mandate should be done properly and, perhaps, in stages with a relative degree of consensus of buy-side, sell-side and major SEF market participants. I would be interested to consider comment letters that suggest minimum conditions (such as listing on multiple SEFs) with adequate time for SEF connectivity and onboarding before any new mandatorily cleared swaps become mandatorily SEF traded.[7]

I also heard concern with the proposed restrictions on off-SEF, pre-trade communications. Our goal here was to address the separation of liquidity formation and price discovery from trade execution on existing SEF platforms that took place upon the implementation of the current rules. The proposal utilizes a carrot and stick approach by, on one hand making the SEF environment more salutary to all such activities and, on the other, prohibiting off platform pre-trade communications for purposes of SEF liquidity formation and price discovery.

It may be that in attempting to bring pre-trade communications onto registered SEFs, the proposal may threaten to disintermediate essential client relationships and communications between buy-side and sell-side market participants in current non-MATT products. This was not intended and is certainly worth further consideration. I would be interested to consider comment letters that address whether the objective of encouraging the full process of liquidity formation, price discovery and trade execution to take place on SEF platforms is sufficiently furthered by the proposal’s efforts to make the SEF environment more salutary to all such activities without needing to prohibit off platform pre-trade communications.

Also, let me address concerns with the proposal’s revisions to the standards for “impartial access.” Several firms with whom I met suggested that permissible SEF membership criteria should relate to a member’s actual market activity in particular swaps asset classes and not its broader commercial activities, such as banking services or direct clearing membership. I would be interested to consider public comments whether the revisions to “impartial access” would benefit from minimum standards for SEF membership criteria that are consistent with a SEF’s right to establish such criteria under Dodd-Frank.

These three issues – the process and timing of bringing new products into scope, the proposed restrictions on off-SEF, pre-trade communications and revisions to the standards for "impartial access," along with the broad concern with how the proposal dovetails with reforming our current cross-border rule implementation (that I touched upon earlier in my remarks) – were the concerns most consistently raised in my recent meetings. They are all valid concerns that will receive thoughtful attention and consideration by CFTC staff.

One final point on the proposal: It only applies to CFTC regulated SEFs. It does not extend CFTC jurisdiction offshore to European MTFs or OTFs. Our proposal is deferential to the MIFID-II regulatory regime for swap execution activities in the EU. It is consistent with the goal I have expressed[8] of ending the current bifurcation of the global swaps markets into separate U.S. person and non-U.S. person marketplaces by exempting non-U.S. trading venues in regulatory jurisdictions that have adopted comparable G20 swaps reforms from having to register with the CFTC as swap execution facilities. Therefore, I do not expect our SEF proposal to have any impact on SEF-registration exemptions for EU trading venues consistent with the 2017 agreement reached with the European Commission on trading venue equivalence.

Earlier this week, you may have read a story in the Wall Street Journal asserting that I would "walk away" from the SEF proposal.[9] That assertion is simply wrong. As with any agency rule proposal, we wish to thoroughly understand its possible impact on markets and market participants and will take that into consideration in the process. Any thought of re-proposing the rule is premature before public comments have been received and fully considered and discussions take place with my fellow Commissioners.

Our goal is not to get the SEF rule done at any cost or any timetable, but to get it done right. For that we need well-considered public comment. Staff has received a few requests to extend the comment period. With the shutdown, staff has been unable to engage in face to face meetings with market participants and commentators that customarily take place during comment periods. For these reasons, I intend to seek an extension of the comment period for both the SEF proposal and the name give up RFC until March 15.

Finally, let me ask the question that may be on some minds.

With billions already having been spent to come into compliance with the existing SEF regime and with everybody used to it and with so much other work to do, "Why do this? Why change the current SEF rules?"

Let me tell you why. It is about risk and opportunity.

First, the current SEF rule framework bears risk for market participants. It only works because it relies on a series of no action letters, staff interpretations and temporary regulatory forbearance. Most of those no action letters are time limited and will expire in the future. Staff in this, or a future administration, may well change the various interpretations, guidance and compliance expectations that underpin the billions of Dollars that have been spent. In short, the existing framework is too subjective and an unstable foundation for the long term value proposition of the US swaps market.

Second, the current restrictions on methods of execution may turn out to be, by themselves, a source of trading risk during a liquidity crisis. Moreover, as I explained earlier, non-U.S. market participants continue to avoid U.S. Person financial firms to steer clear of the CFTC's problematic regulations in certain swaps products. This has contributed to global market fragmentation and systemic risk that post-crisis regulatory reform was meant to ameliorate.

On the other hand, improving the SEF rules presents opportunity - opportunity for service innovation by existing and new market entrants that has waned under the current framework. Industry research estimates this proposal will accelerate market innovation leading to an increase of as much as 20% in average daily notional volume on SEFs.[10] We estimate dozens of new SEF registrants. Here is the opportunity to create a regulatory framework that, instead of stifling it, actually fosters innovation, entrepreneurship and increased market vibrancy.

Improving the SEF rules also increases the chance that the SEC will draw on the new framework in whole or in part for their Security-based SEF regime. That presents the opportunity for a comprehensive and unified U.S. regulatory regime for all swaps products, reducing operational and compliance cost and risk.

Perhaps most importantly, improving the CFTC's SEF rules to make them more compatible with the inherent trading dynamics and episodic liquidity of swaps trading will enhance U.S. markets as mechanisms for price discovery and risk mitigation. It will increase their global competitiveness, making them more attractive to global capital and risk transfer.

If I have been consistent in anything in my almost five years at the CFTC, it is in voicing the value proposition of derivatives trading markets as foundational to U.S. economic growth and broad-based American prosperity. Simply put, improving the CFTC's SEF rules is about strengthening a key pillar of the US economy.

I have often said that we should seek neither the most restrictive regulatory framework, nor the most lenient. We should seek the best framework. That is what we are trying to do with the SEF proposal: create a better, more flexible and more durable regulatory framework for swaps execution that will support vibrant markets and broad based American prosperity for a generation or more.

And the time to do so is now. An old English proverb teach us to: "Make hay while the sun shines." The time to shore up our swaps regulatory foundation is now, while markets are robust, not later when they may be under stress.

We can do it if we work together. With the experience and intelligence of the ABA Derivatives Law Bar, we can improve these rules. Let's make the U.S. swaps trading regulatory regime the best that there is. Like our derivatives markets, let's make our regulation the envy of the world.

Conclusion

In closing, let me again say how sorry I am that I cannot be with you at the conference. Enjoy the excellent program.

Thank you.

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[1] *See* CFTC Chairman J. Christopher Giancarlo, Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation (Oct. 1, 2018) [*hereinafter* Cross Border White Paper], *available at:* https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf.

[2] See Commissioner 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/sefwhitepaper(

[3] According to a survey conducted by ISDA, the market for euro interest-rate swaps (IRS) has effectively split. See ISDA, CROSS-BORDER FRAGMENTATION OF GLOBAL INTEREST RATE DERIVATIVES: THE NEW NORMAL? FIRST HALF 2015 UPDATE 1–3 (2015) [hereinafter ISDA UPDATE], http://www2.isda.org/functional-areas/research/research-notes/; see also Philip Stafford, US Swaps Trading Rules Have "Split Market," FIN. TIMES, Jan. 21, 2014, http://www.ft.com/intl/cms/s/0/58251f84-82b8-11e3-8119-00144feab7de.html#axzz3CHQbMKxU. Beginning in October 2013 after the SEF rules' compliance date, European dealers dramatically moved away from trading with U.S. counterparties, beginning to trade almost exclusively with other European counterparties in the market for euro IRS. In October 2013, 91 percent of euro IRS trades took place between two European counterparties, while only 9 percent occurred between a U.S. and a European dealer. By August 2014, these numbers moved to 96 percent and 3 percent, respectively. Recently, in June 2015, 89 percent of euro IRS trades were between two European counterparties, while 10 percent of euro IRS trades were between a European and U.S. counterparty. Compare these figures with those from a month before the SEF rules' compliance date, when 71 percent of euro IRS trades were between two European counterparties and 29 percent between a U.S. and European dealer. This has been a clear shift in trading behavior for European dealers. See ISDA Update, supra, at 3, 15–16. This observation is also supported by an ISDA survey wherein 68 percent of non-U.S. market participant respondents indicated that they have reduced or ceased trading with U.S. persons. ISDA, FOOTNOTE 88 AND MARKET FRAGMENTATION: AN ISDA SURVEY 3–4 (2013), http://www2.isda.org/functional-areas/research/research-notes/page2/. Volumes between European and U.S. dealers have declined 55 percent since the introduction of the U.S. SEF regime. ISDA UPDATE, supra note at 2, 18. Additionally, the average cross-border volume of euro IRS transacted between European and U.S. dealers as a percentage of total euro IRS volume was twenty-five percent before the CFTC put its SEF regime in place and has fallen to just ten percent since. Id. at 18.

[4] See RAPHAEL K. DIDHAM, THE UNIVERSITY OF WESTERN AUSTRALIA & CSIRO ECOSYSTEM SCIENCES, ECOLOGICAL CONSEQUENCES OF HABITAT FRAGMENTATION 1–2 (2010), http://www.els.net/WileyCDA/ElsArticle/refId-a0021904.html.

[5] "arranged, negotiated or executed"

[6] 83 FR 61946, November 30 , 2018, *at*: https://www.federalregister.gov/documents/2018/11/30/2018-24642/swap-execution-facilities-and-trade-execution-requirement

[7] Commentators may wish to reference some of the suggestions expressed at the July 15, 2015 CFTC staff industry roundtable on the Made Available to Trade process, at: https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/transcript0715

[8] *See:* Cross Border White Paper.

[9] Gabriel T. Rubin, *Wall Street Backlash Sinks Plan to Transform Swaps Market,* Wall Street Journal, January 22, 2019, *available at:* https://www.wsj.com/articles/wall-street-backlash-sinks-plan-to-transform-swaps-market-11548154800

[10] Kevin McPartland, SEF Rule Changes to Accelerate Innovation in Swaps Trading, Greenwich Associates, June 7, 2018, at: https://www.greenwich.com/fixed-income-fx-cmds/sef-rule-changes-accelerate-innovation-swaps-trading