SPEECHES & TESTIMONY

Keynote Address of Commissioner Dan M. Berkovitz at DerivCon 2019, New York, New York

Improving Swap Market Regulation: Four Reforms

February 27, 2019

Thank you ISDA for hosting this conference and for offering me the opportunity to speak with you about our swap markets and potential reforms.

Before I begin, I am obligated to remind you that the views I express today are my own and do not represent the views of the Commission, its staff, or any of my fellow Commissioners.

I am going to talk today about the original policy goals for swap execution facilities ("SEFs"), how well the existing SEFs have achieved those goals, and some changes I believe will improve swap trading.

I support a fact-based approach to market regulation. Rules governing our financial markets should be based on objective facts and data about how the markets are functioning. We should not make fundamental changes to our regulations where the data indicates that the regulations and markets are functioning well and achieving their intended purposes.

I am very happy to report to you today that according to the data, SEFs are achieving many of the goals for which they were established. Just over ten years ago, there was almost no electronic trading of swaps and little visibility into the swaps markets. Although SEFs have only operated for about five years, ISDA's most recent annual data show that about 55% of interest rate swaps and 97% of the main index credit default swaps were traded on SEF.[1]

This is a remarkable achievement.

There is even more progress to report. The CFTC's swap trading rules have led to more competition, more electronic trading, better price transparency, and lower spreads for swaps traded on regulated platforms. SEFs and the market participants that trade on the SEFs – including many of you in this room – deserve the lion's share of the credit for these accomplishments.

As I will explain, the methods of trading may not have turned out exactly as envisioned by the drafters of the SEF legislation and regulations. The drafters anticipated much more exchange-like trading of swaps, where dealers and customers could trade together electronically with posted bids and offers.

Yet in large part, the policy goals for the rules are being met. The current regulations and markets are working for the benefit of end-users. This is something we all should recognize and applaud.

So, where do we go from here? In my view, it would be a mistake to overhaul a system that is achieving many of its objectives. Instead, we should continue to look for ways to improve on this already strong foundation. Later in my remarks I will identify four specific reforms that would further enhance the system now in place.

I had the privilege to serve as General Counsel of the CFTC during Congress's consideration of the Dodd-Frank Act ("Dodd-Frank"). It was exhilarating to work with the Congress, the new Administration, and industry to create an entirely new regulatory framework for our financial markets; to make them stronger, safer, and better able to serve the nation's economy. I continued in that role at the CFTC for the next few years as we developed the implementing regulations. As many of you may remember, this too was an intense experience.

After I left the CFTC, I spent over four years in the private practice of law. During that time, I advised SEFs, swap dealers, brokers, and end users on how to comply with the CFTC swap trading regulations. I saw how much work it takes to develop a SEF, create a rulebook, develop products, understand the cross-border rules, comply with reporting and recordkeeping requirements, and—yes—respond to many CFTC requests for information.

I recognize that it is through the dedication and hard work of you and your colleagues in this industry that the SEF markets today in many respects are accomplishing the purposes of the Dodd-Frank Act and the CFTC's regulations. You deserve credit for and we should be proud of this progress.

WHAT WAS INTENDED

People often ask me: what did Congress really intend in Dodd-Frank for the trading of swaps? And do the CFTC's SEF regulations meet that intent?

I strongly believe that they do. The swap trading provisions in the Dodd-Frank Act were intended to establish a trading framework consistent with the commitments made in September 2009 at the G20 summit of world leaders in Pittsburgh. The Pittsburgh Summit was convened in the wake of the global financial crisis to set forth principles that the nations of the world should follow to make the global financial system safer and prevent future crises.

With respect to swaps trading, the G20 leaders declared: "All standardized OTC derivative contracts should be traded on exchanges or *electronic* trading platforms, where appropriate . . . ."[2] Where did this language come from? It came from the United States Treasury Department.

Let me explain. A few months before the Pittsburgh Summit, the Treasury Department sent to Congress a comprehensive proposal for financial regulatory reform.[3] Regarding the trading of OTC derivatives, the Treasury advocated "moving the standardized part of these markets onto regulated exchanges and regulated transparent electronic trade execution systems . . . ."[4] The world leaders in Pittsburgh adopted the Treasury's language practically verbatim.

The Dodd-Frank legislation was designed to meet this commitment.[5] Congress understood that swaps are different from futures and therefore did not prescribe that swaps be traded exactly like futures.

But the drafters of the legislation specified that many of the principles that applied to futures exchanges, which worked well during the crisis, should apply to the swaps market, particularly for standardized swaps that are more like futures. These principles included pre-trade transparency, electronic trading, and the ability of participants to interact with each other, not just a single dealer. The legislation was not specific as to how to accomplish these objectives. That was left to the CFTC's discretion.

The SEF rules adopted by the CFTC in 2013 were designed to bring these principles of exchange trading to the swaps market. Part of this design includes required methods of execution for liquid swaps. The expectation was that if the SEF regulations mandated impartial access, order books, and RFQs, then those mechanisms would eventually be adopted, at least for the more liquid and cleared swaps. The CFTC regulations do not require bespoke swaps to be traded on a SEF. If they are, any method of execution may be used.

WAS THE ORIGINAL INTENT ACHIEVED?

As I mentioned earlier, the drafters of the CFTC's regulations pictured a market structure that would be somewhat different from the current evolution. The order book is used less than expected. RFQ is used more than expected. There are still major markets where dealers trade only with other dealers. Proprietary traders have generally not entered the market. The universe of swaps made-available-to-trade has achieved a steady-state, rather than continued to expand.

Nonetheless, I think many of the drafters would agree that we have made tremendous progress towards accomplishing the goals of the legislation and regulations. For example, the RFQ system is working for many interest rate and index credit default swaps that are traded on SEF. RFQ trading is providing better pricing for swap customers.

Studies by the Bank of England, economic academics, and the CFTC's own economists have documented the benefits of the current regulations and market structure, in terms of tighter spreads and lower transaction costs. I encourage you to review my dissenting statement to the proposed SEF rule amendments where I identify and summarize these studies.[6]

THE PROPOSED SEF REGULATIONS

The proposal issued by the Commission last November to overhaul the SEF rules ("Proposal") is inconsistent with the swap trading provisions of the Dodd-Frank legislation and our G20 commitments. The Proposal would abandon the methods of execution requirements that ensure that SEFs enable market participants to trade highly liquid standardized swaps with each other openly and competitively. The Proposal would gut the impartial access requirement and instead permit SEFs to discriminate against entire classes of market participants.

In tandem, the removal of the requirements for impartial access and competitive methods of execution for sufficiently liquid standardized swaps would revert the swap markets to the pre-crisis, pre-reform era when markets were opaque and nearly all swaps were traded with dealers through voice brokers or on single-dealer platforms. Although the Proposal repetitively claims that new flexible methods of execution will suddenly appear and reduce costs, the Proposal does not provide a single example of a new method of execution that will provide better swap pricing than the RFQ or Order Book. This Proposal will darken the markets and increase prices for swap customers.

These are not the only major changes called for by the Proposal. In fact, the Proposal amends nearly every provision in the SEF regulations. Though I do not have time today to catalogue all of the issues this presents, I will mention just a few more.

The Proposal would mandate that all cleared swaps – even the illiquid ones – be traded on a SEF, which would impose considerable new requirements and costs upon market participants without commensurate benefits. The Proposal would mandate all pre-trade communications to be on-SEF, even for highly bespoke products that may require pre-trade structuring. The Proposal would dismantle requirements for straight-through processing that are necessary to make trading efficient and impartial. Nearly all introducing brokers for swaps now would have to register as SEFs themselves or become "SEF trading specialists," a new category of market participant.

These are all fundamental changes to the market. As a practical matter, the Proposal would disrupt the SEF trading framework that has been working and that the industry has invested substantial sums of money in building. It would require significant new expenditures by SEFs and market participants to retool trading infrastructures, procedures and strategies. Not only is the proposed overhaul unnecessary and costly, but from a public policy perspective, the Proposal would drag the SEF platforms and trading structure further away from the original policy goals.

WHERE DO WE GO FROM HERE?

As we move forward, we should build on our progress, not tear it down. We should broaden participation in these markets, not restrict it. And we should foster competition, not impede it.

I propose an alternative path forward to increase participation, promote competition, and reduce concentration within the existing framework. These changes would lead to better prices, smaller spreads, and healthier markets.

One of the unforeseen developments in the swaps market since the passage of Dodd-Frank has been the increase in concentration in both trading and clearing. Although the Dodd-Frank reforms may have helped increase competition in the swaps market, there are still not enough competitors. The CFTC's swap data shows that swap trading and clearing is concentrated in the largest bank dealers and futures commission merchants ("FCMs").

For swaps trading, the five largest registered swap dealing financial institutions were party to 70% of all swaps and 80% of the total notional amount traded.[7]

Large Swap Dealer
Market Concentration[8]

Swap Dealing Financial Institutions[9]	Party to Swaps[10]	Percent of Notional Amount
5 largest	70%	80%
10 largest	78%	93%

Concentration in swap clearing is also increasing. The five largest FCMs—all of which are affiliated with large banks—provide clearing services for about 80% of cleared swaps.[11] The eight largest firms clear 96% of cleared swaps. A single FCM clears over 27% of cleared swaps.

The Financial Stability Board says the concentration in clearing may be a source of systemic risk.[12] Observing that the provision of clearing services for swaps is "generally concentrated," the FSB warns:

> [C]oncentration in clearing service provision could amplify the consequences of the failure or withdrawal of a ma
> provider. In particular, concerns have been expressed about the ability to port client positions and collateral in tl
> situation.[13]

IMPROVING SWAP TRADING: FOUR REFORMS

Rather than rewrite the SEF trading Regulations, I favor a targeted, data-based approach to increase liquidity and competition.

One of the purposes of the Commodity Exchange Act is to "promote . . . fair competition."[14] I am not proposing to inhibit large dealer activity in competitive markets. I recognize their important role in the swap markets. Rather, we should take steps to encourage new sources of liquidity that will increase competition and price discovery, and will also reduce systemic risks. The changes I am proposing will increase the diversity of liquidity providers in the swap markets, increase competition, and increase the availability of clearing without disrupting the existing system.

I support four specific reforms: expand floor trader registration, abolish name give-up, enable average pricing, and fix the leverage ratio.

Expand Floor Trader registration. Many proprietary traders make markets in swaps without the traditional dealer-customer relationships. CFTC studies have shown that in times of market stress, principal trading firms have remained in other markets as an important source of liquidity.[15]

To accommodate this type of market making, which provides substantial liquidity and price discovery, the Commission provided a simpler floor trader registration as an alternative to full swap dealer registration.

Many of these proprietary traders act as market makers in futures, equities, and FX markets and have expressed interest in doing so for liquid swaps. Unfortunately, the current floor trader rule has proven to be overly restrictive and not a viable way to gain entry into our markets. The Commission should amend the floor trader provision so that the proprietary market makers can become an alternative source of liquidity for standard swap trading on SEFs.

Abolish Name Give-Up. The Commission should prohibit the practice of name give-up for certain anonymously traded and cleared swaps. Name give-up is a major deterrent to non-dealer market makers and buy-side firms who would like to participate in what are now dealer-only markets. Name give-up provides the dealers valuable information about a counterparty's positions. It is unnecessary for cleared swaps traded anonymously for which pre-trade credit clearance occurs. We should eliminate name give-up for the cleared interest rate and credit default swaps that are made available to trade on SEFs and DCMs.

Enable average pricing. Investment managers use average pricing, which is available in futures markets, to allocate trades to different funds under management. Average pricing is not available for many swaps traded on SEFs.

These investment managers provide significant sources of liquidity. The Commission should work with market participants and SEFs to enable average pricing for buy-side swap trades.

Revise bank capital requirements impacting bank FCMs. The bank capital requirements imposed by the prudential regulators include a provision called the supplemental leverage ratio, or "SLR." The SLR requires banks to hold an amount of highly liquid capital determined by the total assets held by the bank. The greater the amount of assets, the greater the amount of required capital.

The SLR regulations, under both current law and the prudential regulators' proposed revisions to how the SLR is calculated, require a bank FCM that is holding a customer's initial margin to count the margin as bank assets subject to the SLR even though these funds cannot be used as leverage. The SLR capital requirements therefore increase the cost of clearing without a commensurate benefit.

As currently drafted, the SLR works at cross-purposes with the provisions of the Dodd-Frank Act that encourage swap clearing. The Commission should continue to work with the prudential regulators to ensure that bank capital requirements are adequate from a risk perspective, but do not discourage the provision of clearing services by bank FCMs.[16]

CONCLUSION

Some of you may be familiar with the legal concept of "*stare decisis*." In Latin, this means "to stand by things decided." In other words, a court should not overturn a prior decision without good reason. I'm not a judge, but it seems to me that a similar principle should guide regulatory agencies. We should not overturn existing rules without good objective reasons. You can imagine the upheaval to industry and the public if rules were changed every time a regulator had a new idea about how the markets "should" work.

In preparing these remarks I looked up the phrase "stare decisis." It is part of a longer Latin phrase: *stare decisis et non quieta movere*, which means "stand by the thing decided and do not disturb the calm."

Here in America, we don't need to speak Latin. We have a perfectly good expression that captures the same idea:

"*If it ain't broke, don't fix it.*"

I look forward to reading your comments on the SEF Proposal and to working with you on targeted reforms that enhance the safety and competitiveness of our markets.

THANK YOU.

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[1] ISDA, SwapsInfo Full Year 2018 and Fourth Quarter of 2018 Review, at 2-4 (Jan. 2019), http://isda.informz.net/z/cjUucD9taT03MjYwNzA2JnA9MSZ1PTg0MzU0Nzk3MyZsaT01NTMwNDMyMQ/index.html.

[2] G20, *Leaders' Statement: The Pittsburgh Summit*, at 9 (Sept. 24-25, 2009), https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders _statement_250909.pdf (emphasis added).

[3] U.S. Dep't of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), https://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf.

[4] The Treasury's proposal also addressed clearing and reporting:

> Market efficiency and price transparency should be improved in derivatives markets by requiring the clearing of standardized co through regulated CCPs as discussed earlier and by moving the standardized part of these markets onto regulated exchange regulated transparent electronic trade execution systems for OTC derivatives and by requiring development of a system for timely re of trades and prompt dissemination of prices and other trade information.

Id. at 48. At his confirmation hearing in January 2009, Secretary Geithner first articulated the new Administration's goal of moving the trading of standardized swaps onto exchanges: "We want to make sure that the standardized part of those markets moves into a central clearinghouse and on to exchanges as quickly as possible . . . ." Hearing Before the S. Comm. on Finance, Nomination of Timothy Geithner, 111th Cong. 52 (Jan. 21, 2009) (testimony of Timothy Geithner), available at https://www.finance.senate.gov/download/2009/01/21/nomination-of-timothy-f-geithner. Similarly, Gary Gensler, the Administration's nominee to be Chairman of the CFTC, stated in his confirmation hearing, "[W]e must now urgently develop a broad regulatory regime for over-the-counter derivatives. Standardized products need to be brought onto mandated clearing and mandated exchanges." Hearing Before the Senate Committee on Agriculture, Nutrition and Forestry, Nomination Hearing to Consider Gary Gensler to be Chairman of the CFTC, 111th Cong 10. (Feb. 25, 2009) (statement of Mr. Gensler), available at https://www.agriculture.senate.gov/hearings/nomination-hearing-to-consider-gary-gensler-to-be-chairman-of-the-cftc. In a letter dated March 26, 2009 to Senate Majority Leader Harry Reid, Secretary Geithner more specifically stated the Administration's objectives on regulatory reform for the derivatives, using language identical to that which later appeared in the June document (available in author's files).

[5] The Conference Report on the legislation contains language similar to the G20 commitments: "Mandatory trading on an exchange or [swap execution facility] should the transaction be cleared and a facility will accept it for trading." Dodd-Frank Wall Street Reform and Consumer Protection Act, Conference Report To Accompany H.R. 4173, H.R. Rep. No. 111-517, 111th Cong., at 869 (June 29, 2010).

[6] *See* Dissenting Statement of Commissioner Dan M. Berkovitz, 83 Fed. Reg. 61946, 62144. *See also* Evangelos Benos, Richard Payne & Michalis Vasios, *Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act*, Bank of England Staff Working Paper No. 580 (May 2018); Pierre Collin-Dufresne, Benjamin Junge & Anders B. Trolle, Market Structure and Transaction Costs of Index CDSs (Sept. 12, 2017); and Lynn Riggs (CFTC), Esen Onur (CFTC), David Reiffen (CFTC) & Haoxiang Zhu (MIT, NBER, and CFTC), *Swap Trading after Dodd-Frank: Evidence from Index CDS* (Jan. 26, 2018).

[7] There are about 60 distinct corporate families that have registered swap dealers. Of those 60 swap dealers, 5 are party to 70 percent of all reported swap transactions and 80 percent of the notional value of all swaps reported.

[8] Swap Data Repository data for calendar year 2017. For more details on the data set used, *see* Notice of Proposed Rulemaking, De Minimis Exception to the Swap Dealer Definition, 83 FR 27444, 27449-50 (June 12, 2018). A recent report by Greenwich Associates makes similar findings. *See Top Dealers Continue to Dominate Swaps Business*, Greenwich Associates (January 31, 2019), https://www.greenwich.com/fixed-income/top-dealers-continue-dominate-swaps-business-0.

[9] CFTC registered swap dealer data aggregated by corporate family (i.e., a number of financial institutions register more than one subsidiary as swap dealers. The swaps for the family are aggregated for this table.) The "5 largest" institutions represent the five corporate families that were party to the highest aggregate gross notional amount ("AGNA") of swaps per family in 2017. The "10 largest" institutions represent the top 10 families by AGNA.

[10] A swap trade is counted for the five largest or ten largest cohorts if at least one swap dealer in the cohort is a party to the swap. The trade or notional amount is counted only once for the cohort to eliminate double counting within the cohort. For example, if both parties to a swap were in the same cohort (e.g., the first and third largest institutions were parties to the same swap transaction), then the notional amount is counted only once for the "5 largest" cohort.

[11] Concentration numbers for clearing services are calculated from data reported by FCMs and released in CFTC's Financial Data for FCMs, as of December 31, 2018, under entry "Customer Account Cleared Swap Seg Required," available at https://www.cftc.gov/sites/default/files/2018-12/12%20-%20FCM%20Webpage%20Update%20-%20December%202018.xlsx.
[12] Financial Stability Board, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms—final report* (Nov. 19, 2018), http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf.
[13] *Id.* at 3.
[14] 7 U.S.C. § 5(b).
[15] U.S. Dep't of the Treasury, Bd. of Governors of the Fed. Reserve Sys., Fed. Reserve Bank of New York, U.S. Sec. and Exchange Comm'n, U.S. Commodity Futures Trading Comm'n, Joint Staff Report: The U.S. Treasury Market on October 15, 2014, at 21 (July 13, 2015), https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf ("During the event window, the data show that the relative share of PTF trading activity increased as prices and volumes rose sharply (9:33 to 9:39 ET), comprising about 73.5 percent and 68.4 percent of trading volume in 10-year note cash and futures markets, respectively, while the relative share of bank-dealer trading activity declined to 21.4 percent and 14.1 percent."); *see also* CFTC Staff Report, Sharp Price Movements in Commodity Futures Markets, at 13 (June 2018), https://www.cftc.gov/sites/default/files/2018-06/SharpPriceMovementsReport0618.pdf ("[T]his work appears to dispel at least one contemporary narrative: the notion that recent changes in market structure, particularly the growing presence of principal trading firms and high frequency trading, has in some way made markets less stable. DMO staff's research does not support this narrative.").
[16] On February 15, 2019, Chairman Giancarlo, Commissioner Quintenz, Commissioner Benham and I submitted a comment letter to the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation on the proposed rulemaking to implement a new approach for calculating the exposure amount of derivatives contracts under the agencies' regulatory capital rules, urging that initial margin not be included in the calculation of the SLR. Our letter is available at: https://www.cftc.gov/sites/default/files/2019-02/SA-CCRCommentLetter021519.pdf.