SPEECHES & TESTIMONY

Remarks of CFTC Chairman J. Christopher Giancarlo at the DerivCon 2019 Conference, New York, NY

February 27, 2019

It is good to be back at DerivCon, or should I say, SEFCON.

Some of you may know that I had a hand in putting together the first SEFCON in 2010, along with Chris Ferreri, Julian Harding, Scott Fitzpatrick, Shawn Bernardo and Steve Merkel. My compliments to them and the WMBAA for the foresight in creating this important conference. And my compliments to ISDA and the Tabb Group for keeping it going. It is remarkable that issues in SEF trading remain so topical nine years later.

I was honoured to give welcoming addresses at SEFCONs I, II and III. And, after a three-year hiatus I gave a keynote address at SEFCON VII. Last year, I spoke at SEFCON VIII, then renamed DerivCon I. Today, I am speaking to you from DerivCon II (which is actually SEFCON IX). It is too early to tell whether I will speak at DerivCon III (SEFCON X). If so, it surely will not be as CFTC Chairman. Whatever the case, I have a feeling that the issues we discuss today will still be issues a year from now, a decade after they were addressed at the first SEFCON.

In any event, I am pleased to be here with you today and delighted to be back in New York City.

Entity Netted Notional Amounts

When I spoke to you last year, I announced some important work by the CFTC's Office of Chief Economist. That was the development of "entity netted notionals" or "ENNs," a new and more risk-based method of measuring the size of the interest rate swaps market.
I am pleased to tell you that development of ENNs continues. Recently, some of our economists have furthered the ENNs methodology to measure markets for corporate and sovereign CDS and FX swaps. If you haven't seen that work, I highly recommend you do so. You can find the published work on the CFTC website. [i]

Bridge Over Brexit for US / UK Swaps Markets

As you may be aware, I was in London on Monday, where the CFTC along with the Bank of England (BoE) and the Financial Conduct Authority (FCA), and with support from Her Majesty's Treasury, issued a joint statement providing assurances to market participants on the continuity of derivatives trading and clearing activities between the UK and US regardless of the outcome of the UK's withdrawal from the EU.

To my mind, London is, and will remain, a critical global center for derivatives trading and clearing. The complex and sophisticated market infrastructure of wholesale derivatives trading and servicing that takes place in London cannot be readily replicated in any other financial center. The integrity of that infrastructure is of critical importance to the United States.

That is why the measures we announced on Monday provide a bridge over Brexit. They are meant to maintain access to that infrastructure and, more broadly, enhance the continued relationship of two of the most important financial markets in the world.

Together, the four authorities are taking measures to avoid regulatory uncertainty about the continuation of derivatives market activity between the UK and US. These measures should give confidence to market participants about their ability to trade and manage risk across the Atlantic.

It is a great credit to the decades-long cooperation between the Bank of England, the Financial Conduct Authority, Her Majesty's Treasury, and the CFTC that we are able to work together to take these steps. They include the CFTC undertaking to extend regulatory relief to UK firms that is currently granted to EU firms. This will be accomplished by issuing new no-action letters to UK market participants that confirm the continued application of existing relief to EU market participants. The CFTC also intends to grant new substituted compliance and exemption orders to confirm that existing orders directed at the EU also will be accompanied by new orders directed at the UK. Additionally, the CFTC has confirmed that UK clearinghouse currently registered with the CFTC will be able to continue providing services in the US on the same basis they do now.

Most importantly, the Bank, FCA, HM Treasury, and the CFTC will continue to coordinate closely, updating our written arrangements and cooperating on matters of regulation, supervision and enforcement. Corresponding preparations for Brexit are also taking place at other US financial regulatory agencies, including the SEC, the US Treasury and Federal Reserve. They are all working in close contact with their British counterparts.

Finally, I wish to recognize, and express my gratitude for, the support of my fellow Commissioners at the CFTC – Commissioners Quintenz, Behnam, Stump and Berkovitz – to effect the measures presented in the statement. It is my honor to serve alongside such fine public servants. I also thank our British colleagues at the Bank of England, FCA, and HM Treasury for joining us in this important announcement.

As the saying goes, we are a people separated by a common language. This week, we showed we are united by a common goal: to support the sound functioning of vibrant and well-regulated financial markets that are the foundation of broad-based prosperity, economic freedom and human aspiration and advancement the world over.

Floor Trader Exclusion

I would like to address a long outstanding issue: the floor trader exclusion. As you may recall, when the Commission established the swap dealer definition, it concluded that "each swap that the person enters into in its capacity as a floor trader…shall not be considered for purposes of determining whether the person is a swap dealer"[ii] if the swap meets a series of eight specific conditions.

Among those conditions, condition "(B)", requires that the floor trader "[e]nters into swaps with proprietary funds for their own account solely on or subject to the rules of a [DCM] or [SEF] and submits each swap for clearing with a [DCO]".[iii]

The ambiguity of this provision – specifically, the word "solely" – has been the source of confusion since its adoption. The Commission and staff have heard from floor traders and potential floor traders, in a number of forums, seeking clarity on this point. We have received requests from potential market makers who have told us that the lack of regulatory certainty on this point has discouraged them from providing liquidity in swaps markets.

I am aware that one possible interpretation of this language could be that if a proprietary trader enters into just one swap that is off-venue or uncleared, then the floor trader can no longer enjoy the benefits of the exclusion from the swap dealer regime.

Such a construction cannot be what Congress intended when they fashioned a Dodd-Frank regime designed to promote competition, SEF trading, and improved price discovery for end users. I know that some of my fellow Commissioners have found this construction to be overly restrictive.[iv] I believe there is support for encouraging increased trading liquidity and competitive prices on SEFs that additional floor traders may provide.

At the end of last year, I asked staff from the Division of Swap Dealer and Intermediary Oversight to develop potential solutions to this problem. They have briefed me on their preliminary recommendations and I've encouraged them to continue their work. DSIO staff has informed me that, should they receive a meritorious request, they are inclined to provide appropriately clarificatory no-action relief to assist registered floor traders to rely upon this exclusion. I look forward to seeing how we can make the floor trader exclusion work the way it was intended.

SEF Rule Changes

I now want to use the remainder of my time to discuss the SEF rule proposals.

In preparing to speak to you today, I went back and looked at the issues addressed at the first SEFCON in 2010. Then, the goal was to inform regulators implementing Title VII of Dodd-Frank about the distinct liquidity, trading and market structure characteristics of global swaps markets. The concern was to avoid a harsh imposition of a US-centric futures regulatory model that supplants human discretion in trade execution with overly complex and highly prescriptive rules in contravention of Congressional intent. Alas, that is exactly what happened.

A few years later, I analyzed the adverse consequences of that flawed implementation: global and national market fragmentation, industry consolidation, absence of innovation and increased trading liquidity risk and systemic vulnerability.[v]

And, that is why last November the Commission put forward an alternative proposal. That was the proposed rule on Amendments to Regulations on Swap Execution Facilities and the Trade Execution Requirement and a Request for Comment regarding the Practice of "Post-Trade Name Give-Up."[vi]

The last time I was here in New York was a month and a half ago during the government shutdown. I spent a week meeting with major participants in global swaps markets, including many SEF platforms, major bank and non-bank swap dealers and market makers, and major asset managers and other buy-side institutions. Every firm I met with expressed a desire to address the new SEF proposal in good faith and in a positive spirit.

Almost all agreed that the current framework is flawed and would benefit from substantial revision. Many recognized that the status quo is too dependent upon no-action relief, staff guidance and temporary regulatory forbearance to be sustainable

There was also broad acceptance of the benefit of making SEF execution methods more flexible and making SEFs themselves more attractive to swaps market participants. There was strong interest in addressing the most burdensome and unworkable aspects of SEF compliance. 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 rules were without constructive criticism. Let me review the major concerns I heard.

New Products

Many of the firms I met with raised the process and timing of bringing new products under the trade execution requirement. In making the "made available to trade (MAT)" trading mandate co-incident with the clearing mandate, our intention was to increase the amount of swaps products traded on SEFs. I heard concerns 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. Some referred to this as the "Javelin Problem." One underlying concern seems to be that some of these swaps are too illiquid to trade on SEFs.

Yet, SEFs currently list on a voluntary basis many swaps subject to the clearing mandate, but not the trading mandate. These swaps can be executed through flexible methods of execution. The SEF proposal would extend this flexible execution method approach to the broader trade execution requirement.

Despite this flexibility, I readily understand that bringing swaps subject to the clearing mandate into scope of the trading mandate should be done properly and, perhaps, in stages. It should also be done with a relative degree of consensus of buy-side, sell-side and major SEF market participants given some of the underlying concerns. I would be interested to consider comment letters that suggest minimum conditions (e.g., such as multiple SEFs listing a swap) with adequate time for SEF connectivity and on boarding before any new mandatorily cleared swap became subject to mandatory SEF trading.[vii]

Let me make one thing clear, however. Right now, there is still a Javelin Problem. Under the current rules the problem remains that any one platform can hypothetically force a product into scope. The problem has not gone away. Maintaining the status quo means doing nothing about the problem.

Pre-Trade Transparency

Some firms expressed concerns that moving to flexible execution methods may reduce the benefits of pre-trade price transparency.

The fact is that both the existing rules and the proposed rules seek to increase pre-trade transparency. They just do so in different ways. The existing rules attempt to do so by restricting customer choice in methods of trade execution for the most liquid swaps instruments. The proposed rules seek to do so by increasing the number and range of transactions traded and executed on SEFs, while permitting flexible methods of execution consistent with the Dodd-Frank Act.

It is worth noting that electronic execution of exchange traded futures products is almost ubiquitous today. Yet, it came about through a five-decade long evolution of incremental commercial developments and technology innovations that transformed yesterday's trading pits into today's electronic futures exchanges. At all times, the impetus was the demand of market participants and the response of market operators to reduce trading costs and transaction friction. At no time did government step in and say, "Henceforth, all futures trading shall be on electronic exchanges." Instead, market evolution happened because a good idea was coupled with capable technology and mutual commercial interest with enough time to catch on and gain traction.

And yet, other derivatives asset classes with more episodic liquidity, like exchange-traded options and many swaps, continue today to trade by voice despite the availability of modern electronic trading technology. That is why the design of trading platforms and the evolution of market structure is best done by platform operators, through trial and error, customer demand, commercial response and technological innovation. Regulators will never be close enough to the heartbeat of the markets, the spark of technology or the cost of development to prescribe the optimal design of trading platforms or business methods.

Some have said that I want to bring the market back to voice trading. That is silly. The current SEF rules already allow voice trading for Required Transactions (i.e., Order Books or RFQs-to-3). I simply want to give SEFs freedom to do what Congress permitted them to do. That is, to conduct their activities through "any means of interstate commerce," and not "any means chosen by regulators." Once regulators step in and dictate who serves whom with what type of service, they are picking winners and losers. Regulators are simply not competent, nor do we have the authority to pick best methods of trade execution.

Congress knew that swaps are not traded by retail participants, but by sophisticated, institutional traders that can demand the transaction services they need without regulatory dictate. And the platform operators are not public utilities, but seasoned competitors. If there is money to be made, trading efficiencies to be achieved, customers to be served or costs to be saved, they will act.

Our SEF proposal will empower customer choice and allow SEFs to innovate to meet demand and operate trading environments that are more salutatory to the episodic nature of swaps liquidity. At the same time, it will permit a broader range of liquidity formation, price discovery and trade execution on SEFs for a greater number of swaps products. If adopted, the proposal will bring "daylight to the marketplace" by subjecting a greater number of swaps to SEF recordkeeping, regulatory supervision and oversight, just as Congress intended.

Let's be clear: restricting methods of execution has stymied market innovation and, when the next crisis comes, will exacerbate loss of trading liquidity. The status quo may well be a source of systemic risk.

Industry Consolidation

In recent remarks, my fellow CFTC Commissioner, Dan Berkovitz forecasted that permitting flexible methods of trade execution and customer choice will lead to market consolidation. Yet, such consolidation has already happened with the swaps regulations that are in place today. Before the introduction of the current SEF rules, there were more than a dozen large dealers active in serving institutional buy-side participants in U.S. markets. Today, according to information cited by Commissioner Berkovitz, the largest five dealing institutions are party to about 70% of all reported swap transactions and 80% of the notional amount traded.

In fact, upon their introduction, we were told that the current rules would address bank dealer domination in OTC derivatives[viii] to achieve "a paradigm shift from the business models of the past."[ix] It is true that there has been such "a paradigm shift," but not one that has broadened the market, but one that has concentrated it.

So, if it is market consolidation with which we are concerned – and we should be – then we should indeed revisit the current rules, under which so much industry consolidation has taken place. The status quo has failed to bring many new entrants into the swaps markets. Market consolidation should lead us to challenge the status quo, not excuse it.

Scope of Pre-Execution Communications

Participants in my New York meetings also voiced concerns with proposed restrictions on off-SEF, pre-trade communications. Our goal 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 new proposal utilizes a carrot and stick approach by, on the 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.

In attempting to bring pre-trade communications onto registered SEFs, the proposal could potentially disintermediate essential client relationships and communications between buy-side and sell-side market participants in current non-MAT products. This was not intended. I will certainly 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.

Yet, let me be clear on this point: the status quo means that SEFs remain little more than trade execution engines. Doing nothing means that a great deal of liquidity formation and price discovery is conducted in off-SEF environments with limited transparency and regulatory oversight. Surely, this was not what Congress envisioned for SEFs.

Impartial Access

There has been much said about the proposed changes to the standard of "impartial access." To consider the matter, it is important to start with the underlying law. Dodd-Frank required SEFs to have rules to provide market participants with "impartial access" to the market. Yet, Dodd-Frank also allowed SEFs to establish rules regarding any *limitation* on access.[x] The statutory reference to *limitation* on access is meaningless if SEFs are required to serve every type of market participant or operate all-to-all marketplaces. It is plain that Congress meant for SEFs to determine their own business model and service offering, so long as they treat potential customers in an impartial manner.

The new proposed rules would allow SEFs to structure participation criteria and trading practices in a manner that aligns with their own service capabilities. However, such criteria must be transparent, fair and non-discriminatory and applied to all or "similarly situated" market participants in a "fair and non-discriminatory" manner, which means that such criteria should be non-arbitrary and based on objective, pre-established requirements or limitations.

I am aware of views that the standards for "impartial access" would benefit from greater specificity. Some have suggested that permissible SEF membership criteria should relate to a member's actual market activity in particular swap asset classes and not to the member's broader commercial activities, such as banking services or direct clearing membership. I will certainly consider public comments on 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.

Again, let me be clear. The current formulation of "impartial access" has not served to prevent significant industry consolidation. The status quo offers little to recommend it against the obligation to follow the plain meaning of Congress.

Existing Equivalence Determinations

Let me address the impact of our proposal on the 2017 equivalence decision by the European Commission (EC) regarding swap trading platforms.

Since becoming Chairman, I told the EC of my intention to implement the ideas laid out in my SEF White Paper. I extended numerous opportunities to discuss any concerns during the course of the EC-CFTC agreement on trading venue equivalence. Of course, the EC has the opportunity to provide formal comments on the rule proposal and I remain in correspondence with EC Vice President Dombrovskis. CFTC staff briefed the EC staff about the proposal at the US-EU Joint Financial Regulatory Forum. By all accounts, the process we have followed in presenting the rule proposal is a model of transparency and dialogue with foreign counterparts.

I would further note that the proposal only applies to CFTC-regulated SEFs. It does not extend CFTC oversight to European MTFs or OTFs. As will be further explored in forthcoming cross-border rules, we seek to continue to be deferential to the EU trading venue regime.

Why Change the SEF Rules?

Okay, so those are the main issues that came up in my January meetings here in New York. But there was also another thing I heard from some market participants –a subtle thing that was not voiced directly, but by implication. That was regulatory fatigue. Ten years after the crisis, market participants are tired of adjusting to enormous changes in market structure driven by regulatory edict. It is understandable that they just want to get on with trading. The current rules are far from perfect, but at least they are understood. With healthy trading conditions, many market participants want to leave the status quo as it is.

I get it. I helped run a large swaps trading platform. I understand the desire for stability in regulatory structure. I understand the desire to maintain the status quo.

Still, I want to make the case that there are two crucial reasons to improve the SEF rules: risk and opportunity.

The current SEF rule framework is highly subjective and poses risk for market participants. It overly relies on a series of no-action letters, staff interpretations and temporary regulatory forbearance that are not intended to provide permanent relief. Staff in this, or a future administration that is less sympathetic to free markets, may well change or withdraw the various interpretations, guidance and compliance expectations that underpin the current framework.

Moreover, the current restrictions on methods of execution may turn out to be, by themselves, a source of trading risk during a liquidity crisis – when swaps counterparties need to be found through less prescriptive and more flexible means of execution.

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. Third-party research estimates the new proposal will accelerate market innovation leading to an increase of as much as 20% in average daily notional volume on SEFs. We estimate dozens of new SEF registrants. It is the opportunity to create a regulatory framework that actually fosters innovation, entrepreneurship, competition and increased market vibrancy rather than stifles it.

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. It would create a common US regulatory approach for all swaps products, reducing operational and compliance costs and risks.

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 markets as mechanisms for price discovery and risk mitigation. We should seek neither the most restrictive regulatory framework nor the most lenient. We should build a framework that is the best. That is what we are trying to do with the SEF proposal: create a better and more durable regulatory framework for swaps execution that will support vibrant markets and broad-based prosperity for a generation or more.

Change of Status Quo

I said at the start of my Chairmanship that my term would be marked by a return to regular order. There would be no final rules rushed through on short time frames. We would take the time needed to get them right.

And that applies to the proposed SEF rules. I have explained this to trade journalists and, yet, they continue to write breathless stories that I will race to pass these SEF reforms before I leave the Commission. That is just nonsense. I want to see the rules made right, not done under any specific time frame.

Yet, that does not mean that we should not act. We should make hay while the sun shines. We must shore up our swaps regulatory foundation now while there is willingness at the Commission to do so and while trading markets are robust, not later when they may be under stress.

You know, twenty years ago there was a CFTC chairwoman, who proposed to review US regulation of OTC swaps at a time of relatively healthy market conditions. She was harshly attacked by some who preferred the status quo (especially by fellow financial regulators in her own party). As a result, nothing was done.

If, instead, steps had been taken then to bring swaps into the traditional principles-based regime of the CFTC, we might not have had to hurriedly address it in the wake of 2008 financial crisis and implement it in as wooden a fashion as was done.

Two decades later, no one should be similarly complacent about the status quo. No one should accept it as satisfactory or sustainable.

I have put before you a proposal – and an opportunity. The proposal surely will receive a lot of comment – as it should – that should well lead to its improvement. More important is the opportunity, an opportunity to create a better framework, one that is more flexible, more durable and more supportive of deep and liquid markets.

The opportunity is at hand. It is the opportunity to improve the status quo. It is up to you – the leaders of global swaps trading markets – to take advantage of this opportunity.

And, one more thing, they say that every Chairman leaves office with a few "I told you so's". Please don't let me leave the Commission with an "I told you so" on SEF trading. I would prefer not to look back in some future crisis and say that we should have fixed the SEF rules when they could have.

Conclusion

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 economic growth and broad-based prosperity. I have often said that the use of commodity futures, swaps and other derivatives is one of the reasons our citizens find plenty of food at stable prices in grocery stores, affordable energy to warm homes and drive cars, and steady rates to pay home mortgages and invest retirement savings. In short, derivatives provide stability and predictability to all of our lives.

As I end my five year term at the CFTC, I remain a champion and defender of free market capitalism and the disciplined and independent financial regulation that safeguards it. It remains foundational to a thriving future of human advancement and potential – a future where creativity and economic expression is a social good all by itself.

Thank you for your time and attention.

[i] See *ENNs for Corporate and Sovereign CDS and FX Swaps*, January 2019, *available at*: https://www.cftc.gov/sites/default/files/2019-02/ENNs%20for%20Corporate%20CDS%20and%20FX%20Derivatives%20-%20ADA.pdf.

[ii] *See* 17 CFR 1.3, Swap dealer, paragraph (6)(iv).

[iii] *Id.* at (6)(iv)(B).

[iv] Remarks of Commissioner Dan M. Berkovitz at the Commodity Markets Council State of the Industry 2019, January 27, 2019, *available at*: https://www.cftc.gov/PressRoom/SpeechesTestimony/opaberkovitz1.

[v] CFTC Commissioner J. Christopher Giancarlo, *Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank*, White Paper, Jan. 29, 2015, *available at:*
http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf.

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

[vii] 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, *available at:* https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/transcript071515.pdf.

[viii] Remarks of Gary Gensler, OTC Derivatives Reform, Atlantic Conference, Jan. 12, 2010, at: https://cftc.gov/PressRoom/SpeechesTestimony/opagensler-24.

[ix] Remarks of Gary Gensler at Swap Execution Facility Conference: Bringing Transparency and Access to Markets, Nov. 18, 2013, *available at*: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-152.

[x] CEA section 5h(f)(2); 7 U.S.C. 7b-3(f)(2).