SPEECHES & TESTIMONY

Remarks of CFTC Commissioner Brian Quintenz at DerivCon 2019

February 27, 2019

Introduction

Thank you for that very kind introduction.

Before I begin, let me quickly say that the views contained in this speech are my own and do not represent the views of the Commission.

The game of Polo was created 2000 to 2500 years ago during the Persian Empire and was first conceived as a training tool for the military cavalry. It quickly developed into a formal competition among nobles, and Persians adopted it as their national sport around 600 AD. Polo spread through various regions in Asia before taking root in India in the 13th century. It wasn't until the mid-1800s during the Colonial Era when it was embraced there by the British, who brought the sport back to the British Isles, formed clubs, and established rules.

One rule, established in the 1930s, outlawed playing left-handed. Polo mallets should only be held and swung with the right hand, the logic went, since, if two players approached the ball from opposing sides while using opposing arms, their horses would collide.

Imagine for an instance how it would change baseball if batters could only bat right-handed. Switch hitters would no longer serve any purpose, nor would left-handed hitters for that matter. Obviously, rules are tailored to the games. Rules created for the safety of one sport may, if unilaterally transposed, undermine another.

The same is true for market regulation. The rules governing trading must reflect the players, their objectives, the markets, and the products; marketplaces are not one-size-fits-all. Neither should be our rules.

The current SEF Proposal[1] would eschew many of the prescriptive requirements of the current regime transposed from the futures "pitch" in favor of a principles-based approach better suited to the swaps "field." It does so in part by allowing SEFs to compete based upon offering the most efficient, cost-effective means of execution that are most attuned to the trading needs of its customers. I believe this greater freedom to innovate will ultimately foster liquidity, attract more participants onto SEFs, lower transaction costs, and promote trade transparency.

In particular, I wanted to emphasize how critical I believe the Proposal's embrace of flexibility and heterogeneity in execution methods is for the health and growth of SEF trading. While some swap products are standardized and highly liquid, many other swap products are bespoke, thinly traded, and prone to episodic liquidity. Yet, the 2013 SEF framework adopted by the Commission relies heavily upon the regulatory framework for futures markets – markets known for their standardization and continuous liquidity. Indeed, in the 2013 SEF Final Rule, the Commission stated that one of its goals was "to harmonize the final SEF regulations with the DCM regulations in order to minimize regulatory differences between SEFs and DCMs…."[2] This Proposal seeks, for the first time, to stop trying to squeeze the swaps market into a regulatory model designed for futures and acknowledges the unique needs of swap market participants to have access to a diverse range of trading methods and protocols that reflect the diversity and complexity of the products traded.

I want to focus on a few aspects of the Proposal that are intentioned to promote competition and innovation among SEFs to the benefit of market participants by removing some of the more prescriptive elements of the current SEF framework. In particular, I would like to focus on (i) gradually bringing more swap products onto SEFs, (ii) expanding the modes of execution available on SEFs consistent with the Commission's statutory mandate, and (iii) reviewing how we think about pre-trade communications.

I am also mindful that, in the Commission's efforts to improve upon the current regime, we need to recognize how and why transparency, liquidity, and competition have increased in swaps trading since 2013 as well as understand that liquidity's vulnerability or resiliency to additional policy changes. Indeed, over the past five years, a significant amount of swaps trading has moved from the OTC markets to regulated SEFs. In the first few months of 2019, approximately 62% of total IRS traded notional occurred on-SEF, about 53% of which was voluntarily traded.[3] This is an impressive achievement and we should seek to build upon it where appropriate. With that goal in mind, there may be aspects of the Proposal – some of which I will touch upon today – that should be implemented or adjusted to better promote price discovery and liquidity on SEFs and create a vibrant, competitive swaps trading marketplace that works for all market participants.

Bringing More Swaps onto SEFs

First, the Proposal would significantly expand the types of swaps required to be traded on SEFs—so-called "Required Transactions"—to be coextensive with the clearing requirement, in line with the statute.[4] In order to facilitate this broader trading mandate, as noted above, the Proposal would also eliminate any required methods of execution – allowing firms to choose the method most appropriate for their trading. I will come back to this point later – but first, more on expanding the trade execution mandate.

Generally, the Commodity Exchange Act (CEA) provides that swaps that are subject to the clearing mandate **must** also be traded on-SEF if **at least one** SEF makes the swap "available to trade."[5] In 2011, when the Commission was first considering what it means for a SEF to "make a swap available to trade," some market participants expressed concern that a SEF might list an illiquid swap for trading in order to establish a monopoly in trading for that swap. In other words, a SEF could have an incentive to be a "first mover" to list a swap, regardless of whether it could effectively be executed on the SEF under one of the restrictive, required execution methods, because, once the swap was listed, all market participants would have to execute it on that SEF until other SEFs caught up.

The Commission tried to address some of those concerns by adopting the current "made available to trade" (MAT) process, which requires SEFs to consider a swap's liquidity before determining that the swap should be "made available to trade."[6] However, it is now clear that the MAT process is broken.

Beyond the initial set of MAT determinations made over five years ago, the Commission has not received any filings for additional swaps – even despite the subsequent expansion of the clearing mandate. Instead of a rush to file MAT applications, SEFs have been reluctant, partially because, as I understand it, some SEFs do not want to be in the business of making determinations applicable to the entire market about what swaps should be mandatorily exchange-traded.

The Proposal would address this problem by eliminating the current MAT process, which is not required or contemplated by the statute. In doing so, I believe the Proposal more faithfully adheres to the CEA's language that ties mandatorily cleared products to mandatory platform execution.

Indeed, many of the swaps subject to the clearing requirement are already being listed and actively traded on SEFs through flexible execution methods, despite the lack of a MAT determination. In 2018, 54% of all SEF trades were non-MAT trades that were voluntarily traded on-SEF.[7] Many of these trades are currently subject to the clearing requirement and are highly standardized, liquid products, like forward rate agreements (FRAs) and overnight indexed swaps (OIS).[8] Extending the statutory trade execution mandate to these products should pose little cost given their liquidity profile and should also achieve the benefits of increased transparency, competition, and platform oversight. Of course, even with highly liquid products, I think market participants and SEFs should be provided with appropriate transition time to implement any technological upgrades and onboarding processes necessary in order to avoid causing any market disruption.

I have also heard from some market participants that there is a subset of swaps subject to the clearing mandate that are not yet, and may never be, sufficiently liquid to be mandatorily SEF-traded. I recognize that the liquidity necessary to support clearing is not necessarily the same as the liquidity necessary to support trading. I believe there are ways to address these concerns in any final rule, for example, perhaps by providing that a swap must be listed by a minimum number of SEFs before becoming subject to mandatory trading. There are likely other solutions as well.

I am interested to hear from market participants about how they think the SEF trading mandate can be appropriately expanded in line with the statute while also being implemented in an orderly and effective manner.

Methods of Execution

Of course, bringing these additional products onto SEFs is only made possible because the Proposal would abandon the prescriptive execution methods for Required Transactions under the current regime. Currently, Required Transactions must be executed on a SEF by either (i) placing a bid or offer through a CLOB that is available to all SEF participants; or (ii) sending a "request for quote" to three other SEF participants.[9] These limitations were established despite the CEA's clear directive that SEFs can facilitate swaps trading "through any means of interstate commerce."[10]

By dictating how Required Transactions are executed, the current regime forecloses any number of alternatives that could create liquidity on-SEF and better address the highly variable, bespoke nature of many swaps. Moreover, given that Order Books have not evolved to be a popular mode of SEF execution, requiring all SEFs to maintain and operate such trading functionality imposes an unnecessary, significant cost on the platforms. [11]

Under the Proposal, the only minimum trading functionality a SEF must have on an ongoing basis is directly tied to the definition of SEF under the CEA, which states that a SEF must operate a "trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other multiple participants … through any means of interstate commerce …."[12] Thus, under the Proposal, so long as the SEF offers "multiple-to-multiple" trading, it may offer any mode of execution it wishes for any swap, regardless of whether it is voluntarily or mandatorily traded on-SEF. Execution methods designed to help create liquidity for bespoke or episodically liquid swaps, like auction platforms or flexibly conducted trade work-up sessions, would be permissible. And if a SEF wishes to continue to offer a CLOB or RFQ-3, it may do so.

Irrespective of the statutory requirement to allow for any means of interstate commerce, some have expressed concerns that eliminating the current restrictive set of execution methods could promote dealer hegemony, resulting in a return to a pre-Dodd-Frank Act world of swaps trading where end-users could even lose access to basic forms of execution like RFQ-3. Instead, they argue in favor of mandating the form and manner of the competitive environment, by restricting the only two forms of acceptable "multiple-to-multiple" trading on SEFs to the CLOB or RFQ-3 for Required Transactions.

These two policy approaches, both supposedly aimed at "promoting" competition, are strikingly different. In my view, one seeks to provide SEFs the flexibility and freedom to innovate and experiment with new methods of "multiple-to-multiple" trading that could be tailored to each product; the other seeks to restrict those methods to a small subset, creating a one-size-fits-all execution regime. The latter approach will inevitably lead to market stagnation, maintenance of the status quo, and disincentives from conducting certain trades on SEFs. In contrast, the Proposal's approach will allow SEFs to actually compete based on the merits of their trading functionality and ability to provide participants with liquidity and competitive pricing.

As a reminder, the CEA as amended by Dodd-Frank makes no mention of Required or Permitted Transactions, nor of the necessity of executing MAT swaps by CLOB or RFQ-3. Instead, the statute, like the Proposal, only requires that SEFs offer platforms that facilitate multiple-to-multiple trading "through any means of interstate commerce." Congress did not dictate the means by which sophisticated market participants should execute their swap transactions. In my view, the Commission's 2013 decision to prescribe execution methods substituted its judgment over the expertise and judgment of market professionals, and, more importantly, is not supported by the statute.

I am interested to hear from others about their views on this topic, and, more broadly, on what the Commission should and should not view as "multiple-to-multiple" trading functionality.

Pre-Trade Communications

Lastly, given the expansion of swaps required to be traded on-SEF under the Proposal, I want to briefly address concerns about pre-trade communications. Currently, counterparties can pre-negotiate the terms of MAT trades, so long as they bring the swap back onto the SEF prior to execution.[13] As a result, a substantial amount of pre-execution negotiation and price formation is currently occurring away from SEFs, only to be brought back onto the SEF immediately prior to execution. The Proposal aimed to move this price discovery and formation process onto the SEF by requiring all pre-execution communications for MAT transactions to occur through SEF facilities – meaning that parties can no longer negotiate terms bilaterally or through brokers.

I have heard concerns that this prohibition could disrupt dealer-to-client trading in certain products due to the nature of negotiations between clients and their preferred dealers on the swap terms prior to execution on-SEF. Understandably, some clients have longstanding relationships with certain dealers and wish to continue to be able to communicate with them directly. I do not think it was the intent of the Proposal to disrupt these traditional trading relationships. That is why the proposal asks many questions on this issue to gain a better understanding. I am also interested to hear from market participants about how pre-execution communications for MAT transactions could be accommodated in a way that would not impede liquidity formation and pre-trade price discovery on-SEFs.

Conclusion

In closing, I look forward to working with all of you to ensure our SEF regulatory framework supports a competitive, vibrant trading environment that works for all market participants. Thank you so much for having me here today.

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[1] Swap Execution Facilities and Trade Execution Requirement, 83 Fed. Reg. 61946 (Nov. 30, 2018) ("Proposal").

[2] Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33476, 33478 (June 4, 2013).

[3] ISDA, ISDA SwapsInfo Weekly Analysis: Week Ending February 22, 2019, http://analysis.swapsinfo.org/2019/02/interest-rate-and-credit-derivatives-weekly-trading-volume-week-ending-february-22-2019/ (citing year-to-date volumes).

[4] Required Transactions can be executed on either DCMs or SEFs, and the Proposal amends certain rules governing the trading of swaps on DCMs. Since most swaps will be traded on SEFs, this speech focuses on rule amendments related to SEFs.

[5] The trade execution requirement does not apply if the transaction is subject to a clearing requirement exception pursuant to CEA section 2(h)(7) (*e.g.*, end-users electing the end-user clearing exception are not subject to the trade execution requirement with respect to that trade). In addition, the Commission may determine that swap transactions exempted from the clearing requirement pursuant to other statutory authority are also not subject to the trade execution requirement (*e.g.*, trades between affiliates).

[6] CFTC Rule 37.10.

[7] What Traded On-SEF in 2018?, CLARUS Financial Technology, Chris Barnes (Feb. 12, 2019), https://www.clarusft.com/what-traded-on-sef-in-2018/. The 54% is measured in terms of notional amounts executed on-SEF.

[8] *Id.*

[9] CFTC Rule 37.9(a)(2)(i). Market participants can also discuss a trade privately with a counterparty off-SEF and then bring the trade back onto the SEF prior to execution by exposing the trade to the CLOB for at least 15 seconds, in order to let competing participants offer a better price. CFTC Rule 37.9(b)(1).

[10] CEA Section 1a(50).

[11] J. Christopher Giancarlo and Bruce Tuckman, Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps 49–50 (Apr. 26, 2018), available at https://www.cftc.gov/sites/default/files/2018-05/oce_chairman_swapregversion2whitepaper_042618.pdf.

[12] CEA 1a(50).

[13] CFTC Rule 37.9(b). After negotiating off-SEF, a counterparty must either place the order on the CLOB for 15 seconds prior to execution to allow another SEF participant to submit a more competitive price, or execute the order through a SEF's RFQ system.