Securities Regulation Daily Wrap Up, CFTC NEWS AND SPEECHES—Commissioner Berkovitz states his opposition to proposed swap trading rules, (Jan. 28, 2019)

Securities Regulation Daily Wrap Up

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In remarks before the Commodity Markets Council State of the Industry 2019 conference, Commissioner Dan Berkovitz lays out a comprehensive argument that the CFTC's proposed swaps trade execution requirement undermines competition

In a speech before the Commodity Markets Council State of the Industry 2019 conference, Commissioner Dan Berkovitz defended his lone dissenting vote on the CFTC's controversial proposed *SwapExecution Facilities and Trade Execution Requirement* rule. The speech, titled *Competition, Concentration, and Cartels in the Swaps Market* focused on the role of free market principles as a cornerstone of the derivatives markets and how the CFTC's proposed trade execution rule actually undermines these objectives. In November of last year the CFTC voted 4-1 to move forward with proposed rule over Berkovitz' vehement dissent.

First principles. Berkovitz led off his remarks positing that free, fair, and competitive markets are the foundation of our economic system. He noted that one of the long standing purposes of the CEA is to promote fair competition. The commissioner also observed that with the Dodd-Frank Act, Congress applied the principles of open markets and fair competition to swaps trading, and that Dodd Frank requires swap SEFs to provide all market participants with impartial access to the market and enable them to trade with many other market participants. He further noted that rules preserving competition, open markets, and level playing fields also are necessary because in any market the largest participants have a tendency to try to tilt the playing field in their favor.

The swap market is concentrated in the hands of a few large bank dealers. Berkovitz pointed to data from the swap data repositories showing that the largest five dealing institutions are party to about 70 percent of all reported swap transactions and 80 percent of the notional amount traded. Likewise, FCM data shows that five bank FCMs provide clearing for about 80 percent of cleared swaps. He noted that these high levels of concentration show that the largest dealers possess considerable market power. Moreover, these high levels of concentration also present potential systemic risks, since the failure of one of these firms in a highly interconnected market could have significant impacts on the other firms in the market.

The CFTC's prosed trade execution requirement would thwart competition in several respects. According to Commissioner Berkovitz, the proposed rule as currently crafted would seriously undermine competitive market forces in a variety of ways. These include:

- SEFs would be able create exclusive markets for swap dealers. The proposal's "exclusionary access" provision would perpetuate and strengthen the current two-tier market structure for cleared swaps. In one tier end-users and proprietary traders would buy from or sell swaps to dealers. In the other tier, dealers trade with each other exclusively and lay off the risks from their swaps at prices that only dealers can access. As a practical matter, under this structure only dealers would be able to economically and efficiently offer cleared swaps to end-users;
- the proposal would effectively repeal the method-of-execution rules that require request-for-quote, known as "RFQ," and order book trading systems for liquid swaps that are made available to trade on a SEF. The Proposal provides no evidence to support its claim that allowing "flexible methods of execution" will

benefit end users. The proposal fails to identify any trading method that can or will provide lower costs to end users than the RFQ method; and

- in the absence of any constraints, the dealers undoubtedly will push trading with non-dealers to less transparent single-dealer platforms and platforms that only allow one-to-one trading where there is no direct, real-time price competition with other dealers.

Berkovitz concluded that these changes would return the markets to the swaps world as it existed prior to the financial crisis and the Dodd-Frank Act. He observed that experience did not turn out well and notes there is ample evidence that the pro-competitive rules put in place by the CFTC after the financial crisis have led to lower prices for end-users compared to the unregulated swap markets that previously existed.

Proposed measures to improve competition. Berkovitz also set forth a number of measures which would improve competition and increase liquidity in the swap markets. Some of these include the following:

- Expand floor trader registration. Expanding the floor trader provision in the swap dealer definition is would permit non-dealer traders who trade large amounts of swaps on SEFs or designated contract markets for their own accounts to register as floor traders rather than swap dealers. Many proprietary traders acting as market makers in futures, equities, and FX markets and have expressed interest in doing so for liquid swaps;
- Revise bank capital requirements impacting FCMs. The Commission should work with the prudential regulators to ensure that bank capital requirements are adequate from a risk perspective, but also do not unduly restrict the availability of clearing services by bank FCMs;
- Abolish name give-up. The CFTC should prohibit the practice of name give-up for most cleared swaps. Under this practice, on many platforms that provide anonymous trading, the identity of a counter party is provided to the dealer after the completion of a trade. Name give-up is a major deterrent to non-dealers seeking to participate on dealer-only platforms as it provides the dealers with valuable information about a counterparty's positions; and
- Enable average pricing. The Commission should work with market participants and facilities to enable buy-side firms to obtain average pricing for buy-side swap trades. Although average pricing is available for futures, it currently is not available for swaps, which limits the direct participation of buy-side asset managers on SEFs.

The proposed *Swap Execution Facilities and Trade Execution Requirement rule* is currently out for public comment. The comment period concludes on February 13, 2019.

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