Securities Regulation Daily Wrap Up, COMMODITY FUTURES—Transparency, proposed swap dealer capital requirements dominate open meeting, (Dec. 10, 2019)

Securities Regulation Daily Wrap Up

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The Commission voted narrowly to re-open comment on a controversial proposal on swap dealer capital rules, while unanimously advancing a proposal on affiliates and adopting final rules to conform its rulemaking procedure to the Administrative Procedure Act.

CFTC Chairman Heath Tarbert suggested that the mix of proposals and one final rule approved at an open meeting of the Commission are evidence of his policy of "tripling down on transparency." A re-opened proposal approved by a 3-2 vote seeks public comment on the capital requirements for swap dealers and major swap participants. A second proposal, unanimously approved, would clarify the inter-affiliate exemption from the clearing requirement. Meanwhile, the unanimous adoption of a final regulation on rulemaking procedure is designed to put CFTC practices on par with the Administrative Procedure Act. The Commission, however, dropped a proposed regulation for administrative and civil settlements from its agenda. As of publication, the text of the proposals and the final regulation were unavailable.

Transparency and *CFTC v. Kraft*. Chairman Tarbert opened the meeting by explaining his goal of enhancing the CFTC's transparency. According to Tarbert, the three items addressed today seek to improve how the CFTC makes, applies, and enforces its regulations. With respect to making rules, Tarbert said the agency's revised rulemaking regulation will facilitate the submission of rulemaking petitions and that, as part of this enhancement, the CFTC will provide a plain English document explaining CFTC rulemaking procedures.

The application facet of today's meeting, Tarbert explained, seeks to elevate notice and comment rulemaking over ad hoc relief granted through no-action letters by largely codifying existing no-action relief. Commissioner Dan Berkovitz, however, disagreed with Tarbert's characterization of the state of affairs at the CFTC in 2010, instead suggesting that the CFTC then held many open meetings and that no-action relief provided a key safety valve given the enormity of the CFTC's task to implement the Dodd-Frank Act.

Lastly, Tarbert announced that, as part of a drive to provide more clarity about CFTC enforcement, the agency's Enforcement Division will soon publish an updated enforcement manual. On a realed topic, Tarbert said Commission staff must be able to speak freely about enforcement matters and that he will not present to the Commission any enforcement matters that are structured in ways that could silence commissioners. Tarbert elaborated, however, by stating that such a principle cannot be one-sided and that defendants and respondents also must be free to speak publicly, although with the caveat that they could not deny agreed statements.

Although Tarbert did not mention the recent case of *CFTC v. Kraft* (the case does appear in a footnote to his prepared statement), the Seventh Circuit's affirmation in that case of the right of individual CFTC commissioners to speak publicly about enforcement matters was clearly not far below the surface of his remarks on CFTC enforcement. That case had been resolved in federal district court by an agreement that purported to limit the ability of the Commission, and potentially that of individual commissioners, to speak publicly about the agency's settlement of manipulation claims against Kraft Foods Group, Inc. and Mondelez Global LLC. The district court ultimately vacated the settlement and the case is once again on a path to trial following a quick trip to the federal appeals court after Kraft alleged misconduct by the CFTC for posting on the agency's website statements by the Commission and by its individual commissioners.

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Berkovitz, one of the commissioners who posted an individual statement on the settlement in *CFTC v. Kraft*, said he "strongly supports" Tarbert's plan to not present matters to the Commission that could limit the ability of CFTC staff to speak publicly. Berkovitz reiterated that he would never agree to a gag clause, citing the Seventh Circuit's decision in *CFTC v. Kraft*. Berkovitz, however, said he was disappointed that a related proposal on administrative settlements, originally scheduled to be considered today, had been removed from the agenda.

SD/MSP capital requirements. The Commission voted narrowly to re-open comment on its 2016 proposal to establish capital requirements for swap dealers (SDs) and major swap participants (MSPs). The discussion often focused on the 2016 proposal's minimum capital requirement based on 8 percent of margin, including whether the breadth of the applicable definition was set correctly and whether the 8 percent threshold should be adjusted higher or lower, all questions posed in 2016. Several commissioners, however, questioned whether CFTC staff were putting so many new questions out for public comment that the draft regulation should instead be re-proposed, a step that may need to occur anyhow once the CFTC receives the renewed public comments on the 2016 proposal.

Joshua Sterling, Director of the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO), said re-opening comment on the 2016 proposal would allow the CFTC to collect additional public comment in light of subsequent events, including the SEC's adoption of related rules. Sterling said the renewed comment period would last 75 days.

Joshua Beale, Associate Director of the DSIO, noted that roughly half of the provisionally registered firms fall within the CFTC's purview, while the other firms have prudential regulators. As a result, there are three basic approaches to imposing capital requirements on SDs and MSPs: (1) The Basel method; (2) the net liquid assets method (adopted by the SEC and which would apply to SEC-registered broker-dealers and potentially to futures commission merchants); and (3) the tangible net worth method (adopted by the SEC for some major security-based swap participants (MSBSPs)).

As an aside, and for purposes of comparison only, the SEC's recently adopted tangible net worth approach applies to all MSBSPs that do not have a prudential regulator and are not SEC-registered broker-dealers. These firms must at all times have and maintain positive tangible net worth, determined under U.S. GAAP, minus intangible assets such as goodwill. However, tangible net worth must include long/short positions in security-based swaps, swaps, and related positions that are marked to market and must include subsidiary liabilities or other obligations that the MSBSP guarantees.

With respect to the 8 percent threshold, Berkovitz asked a series of questions regarding the possibility that CFTC staff might eventually recommend another threshold, such as 4 percent or 2 percent in order to harmonize with the SEC, something Berkovitz said should not be done just for the sake of harmonization. Commissioner Rostin Behnam added that the CFTC staff was contemplating more than a mere re-opening and that the re-opening plus request for comments may run afoul of notice and comment procedures and should instead be handled as a re-proposal.

Commissioner Brian Quintenz said the CFTC should focus less on preparing for the last financial crisis and instead focus on capital requirements consistent with new regulations that did not exist in 2008. Quintenz then spoke of the importance of capital: "The cost of capital may be the most determinative factor in a firm's decision to remain, or become, a swap dealer, or to continue to provide clearing services to clients, in the case of an FCM. If capital costs are too expensive, firms will restrict certain business activities, end unprofitable business lines, or, in some cases, exit the swaps or futures markets altogether. As a result, over time, the swaps and futures markets would become less liquid, less accessible to end users, more heavily concentrated, and less competitive. These are not the hallmarks of a healthy financial system."

Commissioner Dawn DeBerry Stump emphasized the need to get capital regulations "right." According to Stump: "Much has changed since the 2011 and 2016 proposals concerning capital. We need to solicit a more contemporary snapshot of the issues. The matter before us today provides us with an opportunity to rethink our approach to capital and allows us to be more consistent with what other regulators have accomplished."

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Clearing exemption for inter-affiliate swaps. Melissa D'Arcy, Special Counsel in the CFTC's Division of Clearing and Risk (DCR), explained that the proposal to amend the swap clearing requirement exemption for inter-affiliate swaps would have three goals: (1) deal with the March 11, 2014 expiration of alternative compliance frameworks; (2) expand the jurisdictions where a firm can be located (e.g., add the United Kingdom in the event of Brexit); and (3) streamline the regulation to delete unused or unnecessary provisions. On this last point, however, D'Arcy said a firm should tell the CFTC if it would be affected by a deletion from the regulatory text.

Tarbert remarked that the proposal should codify prior CFTC no-action relief; Stump agreed the proposal would achieve that purpose. Quintenz observed that the proposal did not contain relief from the trade exception requirement, something he said he would like to see considered in a future rulemaking.

Behnam asked a series of questions noting that variation margin is a poor substitute in some instances, to which D'Arcy replied that clearing is the best option. Behnam also asked how firms calculate variation margin. D'Arcy explained that firms can choose their method but that the CFTC has little insight into how firms do this. In a follow up question, Behnam asked about enforcement; D'Arcy said CFTC Regulation 50.10 gave the agency enforcement authority and that the CFTC is intent on preventing evasion of the applicable regulations.

Berkovitz closed the Q&A session by inquiring about why the March 2014 expiration date was chosen. Sara Josephson, from the DCR, explained that it had been expected that other jurisdictions would have regulations in place by that date. D'Arcy added that, in a sense, the CFTC was trying to protect its clearing requirement.

Rulemaking procedure. The Commission adopted a final regulation amending its rules setting forth the agency's rulemaking procedure in order to conform that procedure to the Administrative Procedure Act. The Commission had proposed changes in September that would eliminate all but one section of Part 13 of the CFTC's regulations, the retained portion dealing exclusively with the filing of rulemaking petitions, a procedure not addressed by the APA. The Commission voted unanimously to adopt the final regulation.

The proposed regulation drew but two comments, said Herminio Castro, Senior Special Counsel in the CFTC's Office of General Counsel. Castro added that the final regulation does incorporate some revisions for electronic submissions. Behnam remarked that the other commissioners and CFTC staff had worked with his office on ensuring the usefulness of a webpage that will provide information about CFTC rulemakings.

Companies: Kraft Foods Group, Inc.; Mondelez Global LLC; Mondelez International, Inc.

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