Remarks of CFTC Chairman J. Christopher Giancarlo to the ISDA Regulators and Industry Forum, Singapore

"Optimizing Swaps Trading and Clearing for Our Economic Aspirations"

November 13, 2017

Introduction

Good morning. It's great to be here with you in Singapore.

I am in the midst of a trip through Asia to visit with my regulatory counterparts and derivatives market participants. It is an honor to do so at the same time as our American President.

President Trump often compares the downsized expectations on growth found in the United States with the standards set by Asia. Here in Singapore, it is disappointing if annual GDP growth is less than five percent per year.1 Meanwhile, too many economists and politicians dismiss as unrealistic four percent annual growth in the U.S. economy. Undoubtedly, there are large structural, developmental and scope and scale differences between the U.S. and Asian economies that factor into comparable GDP growth. Still, I believe Americans would do well to emulate the expectations for economic growth found in here in Singapore and elsewhere in Asia. We must have the confidence to expect durable economic productivity and rising standards of living for ourselves and our fellow citizens.

I believe that financial markets, including markets for derivatives and risk, have a critical role to play in fostering economic growth that is both robust and durable. I also believe that financial regulators have a duty to apply the policy prescriptions of their legislators in ways that enhance markets and their underlying vibrancy, diversity and resiliency. That duty also includes the responsibility to continuously review past policy applications to confirm they remain optimized for the purposes intended. It further includes adopting a forward-looking approach that considers the impact of technological innovation and anticipates changing market dynamics.

My remarks this morning are the first of two speeches I will give here in Singapore. On Wednesday, I will speak at the Singapore FinTech Festival and describe the CFTC's forward-looking agenda to address the impact of technological innovation and changing market dynamics.

Today, I would like to take a look backwards at the CFTC's particular implementation of two of the swaps market reforms of the Dodd-Frank Act, namely SEF trading and CCP supervision. I would like to discuss how we can optimize that implementation to better balance market durability with vibrancy and efficiency.

Swaps Execution

I will start with swaps execution.

As you know, I was and remain today a supporter of the swaps market reforms set out in the 2009 Pittsburgh Accords and contained in Title VII of the 2010 Dodd-Frank Act. I believe the policy prescription of the U.S. Congress was clear: swaps should trade on properly regulated platforms with a standard of professional conduct comparable to other financial markets – equities, fixed income and futures.2 That was not the case prior to the passage of Dodd-Frank. In some ways that is still not the case today.3

Trading of swaps products has always taken place in institutional marketplaces. The United States does not permit retail participants to transact swaps products.4 Prior to the financial crisis, swaps traded in two environments: a wholesale marketplace of primary dealer firms intermediated by firms called inter-dealer brokers and a secondary marketplace in which swaps dealers transacted directly with their "buy-side" institutional customers.

Those wholesale marketplaces operated by inter-dealer brokers combined in one location human brokers who acted as agents for their dealer clients soliciting bids and offers and engaging in price discovery with execution platforms where trades were matched and reported back to the legal counterparties. These inter-dealer platforms were "one stop shops" where liquidity could be sourced, prices discovered, bids and offers made and trades executed.

Prior to Dodd-Frank, these inter-dealer platforms were not subject to Federal regulation. This state of affairs was justified on the basis that, as a marketplace without retail participation, U.S.

swaps markets would be adequately self-regulated by its professional participants. Accordingly, inter-dealer brokerage of swaps was not subject to CFTC registration.

Dodd-Frank changed the legal framework by requiring that swaps transactions be traded and executed on regulated platforms called swap execution facilities and that those platforms be licensed by the CFTC.[5] It would seem to follow that the CFTC would have imposed similar measures utilized in other regulated asset classes to raise industry conduct: registration of platforms, standardized codes of personnel conduct and personnel proficiency examinations. But, besides requiring platform registration, the CFTC set off in a different path.

The path the CFTC pursued was an attempt to re-engineer the entire market structure of swaps execution. Instead of raising the standards of conduct of the professionals handling swaps transactions on SEFs, the CFTC sought to dictate the business models of the SEFs themselves. Instead of establishing the SEF regulatory construct to be salutary to liquidity formation, the CFTC turned SEFs into environments that are unconducive to it. Instead of achieving desired outcome, the CFTC's efforts have been effective at achieving unintended ones.

As you know, contrary to provisions of Dodd-Frank that permit SEFs to operate by "any means of interstate commerce," the CFTC's SEF rules were designed to constrain swaps trading to two methods of execution – request-for-quote or central limit order book.[6] While swaps not subject to the trade execution mandate can utilize other methods, the CFTC required SEFs nevertheless to provide an order book for such permitted transactions.[7] All other "required" transactions have to be executed exclusively on one of those two options. Further, the CFTC grafted into its SEF rules a number of market practices from futures markets that are antithetical to swaps trading, such as the 15 second "cross" and execution of block trades off platform. Additionally, the CFTC interpreted SEF core principles in ways that are not conducive to environments in which swaps liquidity is formed and price discovery is conducted.

One effect of this approach is to incentivize the shift of swaps price discovery and liquidity formation away from SEFs to introducing brokers (or "IBs"). Yet, IBs are not appropriate vehicles to formulate swaps transactions. The IB's intended purpose in the CFTC's regulatory framework is to solicit orders for futures transactions, not swaps. IBs are not subject to conduct and compliance requirements appropriate for swaps products. Their employees are required to pass exams for proficiency in serving retail customers for listed futures products, not professional market participants in over-the-counter swaps markets.

Moving swaps price discovery and liquidity formation away from SEFs to IBs is not what Congress intended in Dodd-Frank. The goal was to have the entire process of swap liquidity formation, price discovery and trade execution take place on licensed SEF platforms.

Yet, the trend may be moving in a different direction away from what Congress intended. One may call this the law of unintended consequences. I call it, rather, what happens when regulators get in the business of trying to re-engineer marketplaces beyond their Congressional mandate, especially markets as complex and sophisticated as over-the-counter swaps.

The CFTC should have followed the clear intent of Title VII of Dodd-Frank and left it to the SEFs to determine their business models. It should have recognized that swaps markets have unique challenges in liquidity formation that are only exacerbated by imposing forms and practices taken from listed futures markets. It should have interpreted swaps core principles as principles and not prescriptive and inflexible rules.

What the CFTC should have done is enhance the professional conduct of swaps execution through licensure, testing and adoption and abidance of approved codes of industry conduct. It should have encouraged liquidity formation, price discovery and trade execution to continue to take place in self-contained, licensed SEF environments and then raised the professional standards and regulatory transparency of those environments for the greater benefit and durability of the marketplace.

Yet, it is not too late to take these steps. We are currently considering just such action. Look for us to say more about this in the coming year.

Moreover, I understand that leading SEF operators are working together on a standard code of industry conduct. I commend this important work and look forward to its completion.

Swaps Clearing

Next, I would like to discuss swaps clearing. The most far-reaching and consequential of the swaps reforms adopted through Dodd-Frank Title VII was perhaps the clearing mandate. At heart, clearing serves to promote contract performance, which in turn reduces risk and instills confidence in our markets.

A clearinghouse is the central counterparty (or "CCP") between each side of a swaps contract. Clearing has long existed in other asset classes, including futures and options, so that the two sides of a trade do not have to evaluate each other's creditworthiness each time they enter into

a transaction. This becomes the job of the CCP. Clearing therefore is about risk management. A CCP's job is to apply and execute the safeguards, primarily margin requirements, necessary to ensure that each side of the trade it takes on fulfills its obligations.

Clearing was already beginning to become utilized for swaps transactions before the financial crisis. Since the CFTC issued final rules for clearing in 2012, the impact on the swaps market has been remarkable. ISDA's reporting tells us that in the second quarter of 2017, eighty (80%) percent of trades in both interest rate and credit default index swaps were cleared.8 The default risk of swaps counterparties that was once spread across Wall Street is now pooled and managed within regulated CCPs. That's a good thing.

Yet, while default risk has been localized and reduced through clearing, it has not been regulated away. The efficacy of a CCP-based risk management system depends upon many factors, including sufficient margining to insure against default scenarios, access to liquidity to meet cash calls by its members, and the CCP's ability to vet the counterparties and their trades they send for clearing.

An important tool we have as regulators to gauge this efficacy is CCP stress testing. The CFTC conducted its first multi-CCP stress test in 2016 and recently announced the results of its second stress test. This stress test focused on CCPs' funding liquidity. It reviewed whether three major CCPs could obtain on time the funds necessary to meet the settlement obligations resulting from the simultaneous default of two large clearing members. It also considered whether the need for multiple CCPs to generate liquidity simultaneously had any systemic implications. The hypothetical scenario used for this second test created almost three times as much liquidity demand as would have been created if the two largest firms had defaulted following the Brexit vote.

The recent stress test concluded that all three CCPs had the ability to generate sufficient liquidity to fulfill settlement obligations during the immediate end-of-day cycle, and in the case of those clearing interest rate swaps, during subsequent payment cycles. In addition, the test concluded that, in instances where multiple CCPs used the same methods or the same firm to raise funds, the cumulative size of liquidity requirements would not have impaired the ability of each CCP to meet its settlement obligations on time.

Going forward the CFTC will continue to develop and refine its program of multi-CCP stress testing. We are working toward multi-CCP stress testing that is systemic, recurrent and iterative. We intend to put what we learn from each test into the design of future tests. The goal is to establish a stress testing regime that is thorough, data driven, econometrically sound and reflective of multi-CCP operations and their role in dynamic market ecosystems.

To best develop such a program, the CFTC recognizes the importance of inviting input into stress test design and results from appropriate fellow prudential and market regulators. We will also look to draw upon the insights of leading economists and academics.

Such input will be particularly sought from the Federal Reserve Board, which plays a supporting role to the CFTC in supervising the two domestic American CCPs that have been designated as systemically important financial market utilities (or "SIFMU"s), the failure or disruption of which could threaten the stability of the United States financial system. Input will also be welcome from the Securities and Exchange Commission and the Federal Deposit Insurance Commission, which is the resolution authority under Dodd-Frank.

I am pleased to say that the CFTC and the Fed are determined to develop a closer working relationship when it comes to SIFMU supervision and stress testing. Governor Powell and I have established an inter-agency task force to see it through. We will take the same approach with the regional Federal Reserve Banks in New York and Chicago. Additionally, my staff and I also met recently with Chairman Gruenberg and his team at the FDIC to further similar cooperation.

Going forward, the CFTC intends to seek such input at the initial specification stage of its stress test design and development. Thereafter, the CFTC intends to share its stress test results with participating fellow regulators and garner feedback to be incorporated into future stress tests. I expect that we will have more to say about such an "open architecture" approach to CCP stress testing design in the new year.

Working with Overseas Regulators

I am also open to receiving substantive input into the scope of our stress tests from overseas regulators, particularly the Bank of England and the European Securities and Markets Authority (ESMA), on whose domestic markets U.S. CCPs may have significant impact.

As you may know, I recently expressed concern over the current European Union (EU) legislative proposal for a new EU framework for the regulation and supervision of CCPs. I am particularly opposed to elements of the proposal that would have ESMA subject U.S. CCPs to overlapping EU regulation and supervision without due deference to existing CFTC regulation

and supervision of those U.S. CCPs – due deference that was already agreed to between the EU and the U.S. in the 2016 common approach for transatlantic CCPs.

It is my sincere hope that clear, firm and exact limits on the extent of ESMA's regulation and supervision of U.S. CCPs, consistent with the 2016 common approach, will be part of any final EU legislation.

Let there be no doubt that my opposition to such direct and duplicative oversight of U.S. CCPs by ESMA does not mean I reject ESMA's interest in the prudent operation of U.S. CCPs. Quite the contrary. It is a priority for the CFTC to maintain a professional and constructive working relationship with ESMA. Exchanging input into multi-CCP stress tests should be a valuable component of a healthy institutional relationship between the CFTC and ESMA.

If EU authorities will work with us in a collaborative manner that is deferential to our jurisdiction over our domestic markets, it will find no better friend and partner than the United States in our common goal of reforming swaps markets for greater resiliency and vitality supporting global prosperity.

Conclusion

I began my remarks this morning talking about comparable economic growth rates, the role of derivatives markets in support of economic health and the goal of enhancing market functionality through intelligent regulations.

I want to close by noting that the two topics I discussed speak directly to that goal:

- optimizing the CFTC's SEF rules to enhance market productivity and efficiency, and
- improving CCP stress testing to ensuring that swap markets operate upon a strong and durable foundation.

These and other improvements to our reform of global markets for swaps and other derivatives should help support economic growth not just in the U.S., but elsewhere around the world.

All people – whether they live in America or here in Singapore – aspire to see their families thrive amidst broad-based economic prosperity. Vibrant and resilient financial markets have a critical role to play in underpinning economic progress.

The CFTC intends to do its part to carry out our regulatory mission in ways that enhance markets and their underlying vibrancy, diversity and durability.

Thank you.

1 GDP Annual Growth Rate in Singapore averaged 6.66 percent from 1976 until 2017 https://tradingeconomics.com/singapore/gdp-growth-annual.

2 To execute a trade in equities or bonds in the United States, one must interact with a holder of a Series 7 license working for an NASD registered broker-dealer. To execute a trade of a futures contract, one must transact through a holder of a Series 3 license working for an NFA registered Introducing Broker.

3 SEF personnel handling swaps transactions are not required to pass proficiency exams or hold professional licenses.

4 To transact on a SEF, a participant must be an ECP. CEA section 1a(18). However, non-ECPs may trade on DCMs.

5 Exclusive of "security-based swaps" regulated by the Securities and Exchange Commission.

6 See generally, J. Christopher Giancarlo, Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank (2015), at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf.

7 Such "permitted transaction" order books are barely used.

8 International Swaps and Derivatives Association. "SwapsInfo Second Quarter 2017 Review," August 2017. <https://www2.isda.org/attachment/OTU5MA==/Swaps%20review%20Q2%202017%20FINAL.pdf>

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