

SPEECHES & TESTIMONY

Statement of Chairman Heath P. Tarbert in Support of Proposed Rule on Swap Execution Facilities

January 30, 2020

Before the 2008 financial crisis, swaps were executed bilaterally “over the counter,” rather than on a centralized exchange. When crafting the Dodd-Frank Act in 2010, Congress faced a key decision: Should it require swaps to trade like futures, via a centralized exchange order book visible to the entire market of potential buyers and sellers? Or should it retain the old bilateral, off-exchange trading practices?

This was a difficult decision. After all, the crisis highlighted the need for more effective price discovery in our swaps markets.^[1] For more than a century, centralized exchanges have supported price discovery in futures products by providing a liquid, transparent market for buyers (longs) and sellers (shorts) to come together and transact. On the other hand, swaps are not futures. Many swaps products are executed only episodically through the negotiation of bespoke terms. In the 1990s and 2000s, this was done primarily through various brokers and dealers providing quotes to one another on the telephone or over email. Hence, anonymous electronic trading via a central limit order book (“CLOB”) has not been viable for much of the swaps market.^[2] Even relatively standardized swaps are not typically as liquid as futures contracts and historically did not trade via the CLOB as futures do.

The Creation of SEFs

Ultimately, Congress sought a golden mean that would balance these competing concerns. The Dodd-Frank Act gave birth to the concept of swap execution facilities (“SEFs”). SEFs are platforms on which certain standardized swaps are required to trade.^[3] They resemble centralized exchanges, but have more flexibility in execution methods to accommodate the unique trading characteristics of swaps. In this regard, Congress took an evolutionary rather than a revolutionary approach, recognizing that mandating too much change too quickly could diminish rather than foster liquidity.

In implementing the evolutionary approach of the Dodd-Frank Act, the CFTC required swaps that must be executed on-SEF to trade via the CLOB or a request for quote to at least three SEF participants (“Required Execution Methods” or “Required Methods”).^[4] By contrast, swaps voluntarily traded on a SEF (“on-SEF”) may be executed by any method the parties choose.^[5]

The SEF regulatory regime has generally worked well.^[6] But rarely is statutory implementation perfect on the first attempt. Some requirements are suitable for the swaps market as a whole but do not work well for particular types of transactions. CFTC staff has addressed such issues through a series of no-action letters, many of which have been in place for over six years. With the benefit of this experience, now is the time to begin codifying these no-action letters, with tweaks and refinements where needed.

Through today’s proposal, we continue to strive for the golden mean that strikes the optimal balance between the features of the old bilateral swaps world and those of the anonymous, exchange-traded futures model. In short, we aim to facilitate a natural progression toward more standardized and liquid products with tighter spreads. At the same time, we recognize that certain products that benefit the market do not lend themselves to the Required Execution Methods.

Specifically, this proposal codifies staff no-action letters in three areas: (1) package transactions; (2) error trades; and (3) block trades.

Package Transactions

A “package transaction” typically involves multiple component financial instruments, to be executed simultaneously (or nearly so), with each component transaction contingent on the others. Pricing for certain components of the package is often based on the prices of other components. Certain components of the transaction often hedge other components.

Executing these instruments in package form can improve execution pricing and efficiency, reduce execution costs, and mitigate execution risk, as compared with executing each instrument separately (known as “legging” into the transaction).

In layman’s terms, a package transaction is conceptually similar to booking a flight and hotel for an overnight trip. Each booking’s utility is contingent on the other—making concurrent booking desirable—and there are often opportunities to improve cost and efficiency by bundling the bookings through a travel broker. As a practical matter, the derivatives market is no different.

The proposed rule before the Commission today addresses package transactions that include both (i) one or more swaps that are required to trade on-SEF pursuant to the Required Execution Methods, and (ii) one or more instruments that are not. The Required Execution Methods are suitable for swaps required to trade on-SEF, when such swaps are executed as standalone transactions. But when these swaps are executed as part of a package, they often take on the trading characteristics of the less-liquid instruments in the package, thereby making it unfeasible to execute these swaps via the Required Methods.

This is a part of the market that is itself evolving.[\[7\]](#) However, several types of package transactions include swaps that must trade via the Required Methods under CFTC rules, but currently cannot do so as part of a package. And it is not clear that they will be able to do so in the foreseeable future. Accordingly, today’s proposed rule would codify the no-action relief allowing swap components of those packages to trade through any execution method, provided that the trade occurs on-SEF.[\[8\]](#) I support this reform because it recognizes the progress made toward centralized exchange-type trading for swaps without forcing the market too far ahead of its natural evolutionary process. In addition, we must work to ensure our rules reflect actual market practice and functioning. We cannot rely on staff no-action relief to bridge the gaps forever.

Error Trades

The CFTC, in accordance with the Commodity Exchange Act, has long taken a principles-based regulatory approach to the futures markets.[\[9\]](#) In granting the CFTC jurisdiction over swaps, the Dodd-Frank Act did not repudiate this principles-based tradition, but instead reinforced it. Section 733 of the Act sets forth core principles for SEFs and expressly affords SEFs “reasonable discretion” in determining how to comply.[\[10\]](#)

In this spirit, the proposal sets out a principles-based approach to addressing error trades. It gives SEFs the flexibility to determine the most suitable error trade rules for their markets and participants. At the same time, as I have said repeatedly, principles-based regulation is not a euphemism for “deregulation” or a “light-touch” approach.[\[11\]](#) Accordingly, under our proposal a SEF must require its participants to inform it of error trades and correcting trades, so the SEF can maintain orderly markets and guard against false error claims.[\[12\]](#)

Block Trades

In addition to establishing core principles for SEFs, Congress also set forth two overarching goals for the SEF regulatory regime: (i) promoting the trading of swaps on SEFs, and (ii) enhancing pre-trade price transparency in the swaps markets.^[13] Since their inception, our swaps rules have mirrored analogous futures rules in requiring block trades to occur “away from” a SEF’s trading platform.^[14] This “away from” language makes sense for our futures markets. No participant would *want* to trade a block on a futures market because of the market’s relatively small trade sizes and mandatory use of a CLOB. The moment a block trader enters his or her very large order, the market will likely move against them. Hence, traders would prefer to negotiate the transaction bilaterally, off the exchange.

But swaps have far larger average trade sizes and often already trade via private requests for quotes to particular dealers. Imposing the “away from” requirement artificially forces block trades off-platform, undermining Congress’s unambiguous goal of promoting swap trading on SEFs. Moreover, forcing block trades off-SEF prevents clearing brokers from completing required pre-execution credit checks for cleared swaps, since those checks currently are done only on-SEF.^[15] Pre-execution credit checks are critical to straight-through trade processing, which mitigates counterparty credit risk and enhances execution certainty by minimizing the time between execution and clearing. For these reasons, I support codifying staff no-action relief that currently allows block trades to take place on-SEF.

Conclusion

I expect the proposal, if finalized, will provide certainty and clarity to SEFs and their participants. CFTC staff has provided important relief over the last six years. There is great value in memorializing their no-action positions in a Commission rule.

Furthermore, I remain open to dialogue on further fine-tuning of our SEF rules, consistent with Congress’s mandate as well as the CFTC’s priorities and resources. I therefore will consider introducing further proposals that have the backing of a broad-based consensus of market participants and stakeholders. Swaps markets will benefit most from evolution, not revolution.

[1] See Committee on Cap. Mkts. Reg., *The Global Financial Crisis: A Plan for Regulatory Reform* 55 (May 2009) (“With the real-time availability of both pre-trade quotes and post-trade contract prices, an exchange would thus provide an important source of price discovery that would complement the OTC market and enhance its liquidity.”); Fed. Reserve Bank of Chicago, *Derivatives Overview in Understanding Derivatives: Markets and Infrastructure* 9-11 (2013) (“OTC markets also exhibit low levels of transparency compared with futures markets . . . Further, OTC markets provide limited price discovery; indeed, OTC trading relies heavily on price information generated by exchange-traded markets.”).

[2] E.g., J. Christopher Giancarlo, Commissioner, CFTC, Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank (2015). CLOBs are the modern computerized exchanges that have replaced the open-outcry trading pits of yesteryear.

[3] Specifically, swaps that are required to be centrally cleared must be traded on-SEF unless no SEF makes that swap available to trade. Commodity Exchange Act (“CEA”) § 2(h)(8), 7 U.S.C. § 2(h)(8). The swaps that are required to be cleared are generally the most standardized and liquid classes of swaps.

[4] 17 C.F.R. § 37.9(a).

[5] *Id.* § 37.9(c).

[6] See, e.g., Lynn Riggs, et al., CFTC, *Swap Trading after Dodd-Frank: Evidence from Index CDS*, at 6, 52 (Aug. 17, 2019) (finding that SEF-traded index credit default swap markets are working relatively well following the Dodd-Frank swap trading reforms, though there is always room for improvement); Evangelos Benos, Richard Payne, & Michalis Vasios, *Centralized Trading, Transparency, and Interest Rate Swap Market Liquidity: Evidence from the Implementation of the Dodd-Frank Act*, Bank of England Staff Working Paper No. 580, at 31 (May 2018) (finding liquidity improvement for swaps subject to the SEF trading mandate).

[7] CFTC staff has allowed the relief for certain package transactions to expire as swaps markets and market infrastructure have progressed such that the swap component of these package transactions can be executed through the required methods of execution. See, e.g., CFTC No Action Letter (“NAL”) No. 14-12; NAL No. 14-62; NAL No. 14-121; NAL No. 14-137; NAL No. 15-55; NAL No. 16-76; NAL No. 17-55.

[8] The proposal would also allow any swap that is part of a package that also includes a new bond issuance to trade off-SEF via any means of execution.

[9] E.g., Remarks of CFTC Chairman Heath P. Tarbert at the 2019 Annual Robert Glauber Lecture at Harvard University’s Institute of Politics (Oct. 24, 2019).

[10] CEA § 5b(f), 7 U.S.C. § 7b-3(f) (setting forth core principles for SEFs and providing that a SEF “shall have reasonable discretion in establishing the manner in which [it] complies with the core principles”).

[11] Tarbert, *supra* note 9; Heath P. Tarbert, *Fintech Regulation Needs More Principles, Not More Rules*, Fortune (Nov. 19, 2019), <https://fortune.com/2019/11/19/bitcoin-blockchain-fintech-regulation-ctfc/>.

[12] Such notice need not be separate from the error trade correction process. In addition, while the proposal grants flexibility as to the means of correcting error trades, it does prescribe standards for the *timeframe* for doing so as to cleared swaps. While I encourage public comment on this point, I tentatively believe such timelines are necessary to promote straight-through processing of swap trades for clearing, which is important for the financial integrity of those trades.

[13] CEA § 5b(e), 7 U.S.C. § 7b-3(e).

[14] 17 C.F.R. § 43.2.

[15] See, e.g., CFTC NAL 17-60.