WASHINGTON watch

CFTC Implements Trade Execution Mandate Related to Package Trades

The Commodity Futures Trading Commission on May 1 addressed a critical issue in the implementation of the trade execution mandate for swaps: how to handle "package trades" that involve more than one type of contract but are priced and traded as one transaction.

CFTC staff issued a no-action letter establishing a "phased compliance timeline" for these transactions, which make up a significant portion of the trading activity in the interest rate and credit default swaps markets. The timeline consists of four dates by which certain types of package trades must be executed on swap execution facilities or designated contract markets:

- **May 15:** trades in which all components are swaps that have been "made available to trade" and therefore are subject to the trade execution requirement;
- **June 1:** trades in which at least one MAT swap component and all other components are swaps subject to the clearing requirement;
- **June 15:** trades in which the swap components are MAT and all other components are U.S. Treasury securities (U.S. Dollar Swap Spreads); and
- **Nov. 15:** trades with at least one MAT swap component and at least one component that is either 1) a futures contract (invoice spread) or some other type of instrument that is not a swap, 2) a swap not subject to the clearing requirement, or 3) an equity swap or other type of swap not solely regulated by the CFTC.

The no-action letter also provides further time-limited relief for the clearing of package trades, under which SEFs and DCMs will be able to permit new trades to replace earlier trades that have been rejected for clearing without violating the CFTC's prohibition on pre-arranged trading. The CFTC said this clearing-related relief effectively means that the SEFs can implement a "new trade, old terms" procedure. This relief is subject to certain conditions and will expire on Sept. 30.

CFTC Getting Closer to Clearing Mandate for FX NDFs

The Commodity Futures Trading Commission is finalizing a proposal to establish a clearing requirement for certain non-deliverable forwards, an important segment of the foreign exchange markets.

In a May 6 speech in Chicago, CFTC Commissioner Scott O'Malia revealed that CFTC staff have finalized the NDF proposal for consideration by the CFTC's two commissioners. He also said the proposal will allow for "phased-in compliance" similar to the approach that the CFTC took with interest rate and credit default swaps.

O'Malia did not indicate when the proposal will be issued, but warned that market participants should prepare for a "quick transition" to mandatory SEF trading after the clearing requirement takes effect.

House Agriculture Committee Approves Bipartisan Bill to Reauthorize CFTC

On April 9 the House Agriculture Committee approved, by a voice vote, legislation (H.R. 4413) to reauthorize the Commodity Futures Trading Commission through September 2018.

The legislation—the Customer Protection and End-User Relief Act—also includes provisions to better protect customer assets, it revises the organizational and operational requirements of the CFTC staff, and it provides regulatory relief to end-users. The bill also would require two studies—one on high-frequency trading and another devoted to CFTC budgetary resources and expenditures.

The bill is sponsored by Representatives Frank Lucas (R-Okla.), the committee's chairman; Collin Peterson (D-Minn.), the ranking Democrat on the committee; Michael Conaway (R-Texas), who chairs the subcommittee that oversees the CFTC; and David Scott (D-Calif.), the ranking Democrat on that subcommittee.

The legislation must now be considered by the full House of Representatives. The Senate may also advance its own version of the legislation, which would then be reconciled with the House version before it is sent to the President for his signature.

"FIA commends the House Agriculture Committee for its continued bipartisan approach to developing thoughtful legislation," FIA said in a statement. "While the process of enacting these statutory changes is far from complete, such thoughtful coordination among the various political interests is critical to ensuring that the final product yields a balanced outcome."

Derivatives End-Users Decry Swap Margin Requirements

A report released on March 26 by the Coalition for Derivatives End-Users showed concern among major corporates that margin requirements for uncleared swaps would have a 30% to 40% impact on capital expenditures. The coalition represents hundreds of end-user companies that use derivatives to manage risk.

"An overwhelming percentage of the respondents are concerned about the impact a margin requirement would have on their companies and indicate they would adjust their hedging strategies to account for such a requirement," the study found.

The study has bi-partisan backing from Senators Jon Tester (D-Mont.) and Mike Johanns (R-Neb.), who discussed the results of the study at a briefing along with representatives from the coalition.

The report surveyed the responses from 43 chief financial officers or corporate treasurers from both the public and private sectors including the financial, energy, manufacturing, real estate, healthcare, media and telecom industries. The survey also showed that nearly four in five respondents report that they are concerned about the differences between derivatives reporting regimes in the U.S. and the European Union.

SEC's Gallagher Calls for Substituted Compliance in Cross-Border Oversight

On April 16, Daniel Gallagher, commissioner at the Securities and Exchange Commission, cautioned that U.S. and EU regulations should not be considered the gold standard for emerging markets and he highlighted the importance of substituted compliance when dealing with cross-border transactions. "We at the SEC have made a concerted effort to apply principles of equivalency and substituted compliance in drafting our own rules for the derivatives markets," he said.

Gallagher noted that while many foreign counterparts have regulatory goals similar to the U.S., they have developed different approaches. "There is usually more than one way to achieve any given regulatory objective, and it's not always clear which way is best," he said. "We need to have the regulatory humility to address this fact by permitting compliance with high quality foreign regulatory regimes to substitute for compliance with our own."

Gallagher said regulators should explore ways to leverage relationships with regulators throughout the world to avoid duplicative or contradictory regulations among different jurisdictions. "This does not, however, mean engaging in the type of so-called 'regulatory harmonization' that has come to mean a top-down, forcible imposition of one-size-fits-all regulatory standards on sovereign nations," he said.

He called it "regrettable" that the CFTC initially elected to take an all-encompassing approach to derivatives regulation, but he acknowledged that the CFTC has recently been working more closely with foreign regulators to address their concerns.

SEC Proposes Reporting Rules for Security-Based Swaps

The Securities and Exchange Commission on April 17 voted to propose recordkeeping and reporting rules for security based swap dealers and major swap participants as required under the Dodd-Frank Act.

The proposed rules cover recordkeeping, reporting, and notification requirements and would establish additional recordkeeping requirements for broker-dealers to account for their security-based swap activities.

FIA's Lukken Calls for Regulatory Pragmatism

Walt Lukken, FIA's president and chief executive officer, discussed the implementation of Dodd-Frank in a keynote speech delivered at the SIFMA Compliance and Legal Seminar on April 2. Lukken focused on five broad trends affecting the derivatives industry and emphasized the need for regulatory pragmatism and cooperation as the new rules are put into effect.

"One trend becomes clear: regulatory compliance is going to require a cooperative and pragmatic approach across domestic agencies, foreign regulatory authorities, SROs and private sector compliance departments," Lukken said.

FIA Participates in Congressional Education Roundtable

As Congress continues work on reauthorizing the Commodity Futures Trading Commission and reviewing the Commodity Exchange Act, FIA plans to conduct educational roundtable-type discussions with policymakers.

The first such roundtable discussion was held on April 1 with a small group of freshman Republican members of the House Financial Services Committee and the House Agriculture Committee.

These new Representatives on the Agriculture Committee recently finished their first farm bill and will now be tasked with a review of the CFTC's statutory authorities - a process which is typically conducted every five years.

The discussions are designed to cover basic terms within the Commodity Exchange Act as well as the various components of cleared derivatives market structure and market participants that are regulated by the CFTC.

FIA's government affairs staff plans to engage in similar discussion with Democrats on these committees as well as stakeholders in the U.S. Senate.

FIA Submits Comments to Federal Reserve on Bank Commodity Activities

FIA submitted a comment letter on April 9 in response to the Federal Reserve Board's advance notice of proposed rulemaking regarding the activities of financial holding companies related to physical commodities.

FIA warned against setting new restrictions that would limit the ability of financial holding companies to serve end-users in the physical commodity markets.

FIA added that financial holding companies perform unique functions in the physical commodity markets that are unlikely to be replicated by other market participants.As a result, such restrictions would lead to reduced competition and liquidity and inefficient pricing.

These requirements include maintaining daily trading records for each counterparty and keeping records of trade-related communications such as email, instant messages and telephone calls. The SEC also proposed net capital requirements for security-based swap dealers that are not already covered by the capital requirements that apply to broker-dealers.

Comments must be submitted by July 1.

SEC Approves Self-Trade Rule Proposed by FINRA

On May 1, the Securities and Exchange Commission approved a rule that addresses a complex but important issue relating to electronic trading—the unintentional interaction of orders originating from the same firm. The rule recognizes that some "self-trades" may occur through the interaction of algorithmic trading, but establishes a regulatory framework to prevent such activity from disrupting markets.

The rule was proposed in August by the Financial Industry Regulatory Authority, the self-regulatory organization for the U.S. securities industry, and was modified in response to comments from the FIA Principal Traders Group and others.

As approved by the SEC, the FINRA rule distinguishes between unintentional self-trading activity and wash sales, a type of fraudulent activity in which no change in ownership occurs.

The rule requires firms to adopt policies and procedures "reasonably designed to prevent a pattern or practice" of self-trading that could create "a misimpression of active trading and adversely affect the price discovery process." The rule does not specify a volume of trading that would constitute a "pattern or practice" of self-trading, but provides some guidance on how FINRA will determine when multiple algorithms or trading desks within a firm are related for the purposes of this rule.

CFTC, OFR Agree to Improve Swap Data Quality

Mark Wetjen, acting chairman of the Commodity Futures Trading Commission, and Richard Berner, director of Treasury's Office of Financial Research, on March 31 signed a memorandum of understanding setting out the scope of a joint project to enhance the quality of swap data collected from swap data repositories. The agreement establishes, among other things, a process for assessing the quality of the data. Wetjen and Berner also announced the creation of a staff-level interagency data quality and analytics working group to coordinate the structuring of the joint project.

CFTC Creates Market Risk Advisory Committee

The Commodity Futures Trading Commission is finalizing plans to form a new advisory committee to advise the agency on risk issues. The committee will examine systemic risk issues as well as "the impact and implications of an evolving market structure and movement of risk across clearinghouses, intermediaries, market makers and end-users," the CFTC said in a May 6 notice. The committee also will make recommendations to the CFTC on "how to improve market structure and mitigate risk," the CFTC said. The committee is expected to have 20-25 members with expertise in derivatives and financial markets.