***Julia*: Hello and welcome to a DerivSource podcast. I'm Julia Schieffer, the Founder and Editor of DerivSource.com.**

CFTC Commissioner, J. Christopher Giancarlo, recently released a whitepaper on swaps trading rules, which analyses some of the flaws of how the CFTC has implemented its swaps trading regulatory framework. Now, in this paper the commissioner proposes an alternative framework for regulating the swaps trading market, which is more in line with the original intent and language of Dodd Frank Title VII.

For those of you not familiar with this whitepaper, it's called *Pro Reform: Reconsideration of the CFTC Swaps Trading Rules, Return to Dodd-Frank*.

This paper identifies various adverse consequences of the existing swaps trading rules, including the increase in market liquidity risk and the decrease in technological innovation. Additionally, this whitepaper proposes a pro-reform agenda, which, again, aims to better align with the nature of the swaps market and the original intent of Title VII Dodd Frank.

I assume some of you have not yet had the chance to read this full whitepaper, which is in excess of 80 pages, so luckily for you we have someone with us today who's deeply familiar with this whitepaper and can shed some light on its criticisms and to the proposed pro-reform agenda.

With me today I have Jeff Steiner, Counsel in the Washington DC of Gibson, Dunn & Crutcher.

Welcome to the podcast Jeff.

Jeff: Thanks Julia.

***Julia*: The introduction of new regulation is never an easy or well-received change by all parties, so why are SEF rules under fire first? Why focus on swaps trading rules rather than, say, CCP clearing rules?**

Jeff: The concept of a SEF and a trading mandate were brand new to the swaps market. Sure, market participants utilized electronic platforms in the years leading up to Dodd Frank, but those markets really developed in an organic fashion and they weren't subject to a trading mandate or restrictions on a particular trade execution method. Drafting the final SEF rules, the CFTC really didn't know what the full impact of those rules would be on the market, almost really a chicken and egg situation.

As the whitepaper notes, the agency was aggressive and somewhat restrictive in the manner in which SEFs can list swaps and operate. A number of core principles and other requirements driven out of the core principles, rules that are written in the statute, and then you see things like the Made Available for Trading Mandate and the requirements on how those swaps can get listed.

At this point, I think the agency and others are doing the right thing by looking at these regulations through a more refined lens to see what's working and what's not. Looking at things like liquidity, asking if the rules are actually promoting SEF trading rather than driving market participants to find other alternatives, those are the types of things that the regulators should look at, again because the full impact of how these regulations would affect the market really couldn't have been known at the time that they were written and it does seem like the SEF rules could really benefit from some modification.

With respect to the CCP rules and why those rules weren't looked at first, I think you can contrast the SEF trading rules from the clearing rules. For the most part, mandatory clearing rules have worked pretty well for most market participants. Part of that probably has to do with the fact that many market participants were already clearing swaps. For example, in the credit space folks had been clearing credit default swaps for years, even before the CFTC mandated that they be cleared. So the transition was a lot easier, and I think a lot more intuitive for market participants to accept than this brand new SEF trading and mandatory trading regime that came out.

Julia: **In the whitepaper, Commissioner Giancarlo mentions several adverse consequences of the current swap trading rules. What are the consequences mentioned that you believe to be of most concern, and why?**

Jeff: I think liquidity issues are a really big concern and I think the whitepaper really focuses on those liquidity issues.

Fragmentation for example is harming liquidity and sending capital overseas as non-US persons are looking to trade outside the US on less restricted trading platforms.

We're seeing separate liquidity pools develop for US persons and non-US persons, and the risk is that once this fragmentation develops, and it already has developed to some extent, we aren't going to see those markets come back to the US.

Further, the whitepaper notes the issues surrounding the effects of regulatory action to curtail the use of name give-ups for its impact on market liquidity, which is a really interesting concept brought out in the whitepaper that is: would sell side dealers remove liquidity from the market as a result of restrictive requirements on give-ups?

I think another big concern is the hindrance of technological innovation. The SEF trading rules presume that there are only two acceptable methods for executing a what's known as 'required transaction', that is one that is subject to a trading mandate that must be executed on a swap execution facility or a designated contract market. Those types of transactions, which are *required* transactions, are required to be to be executed either on a central limit order book or with an RFQ process. As the whitepaper explains, there may be better execution methods that provide for greater transparency and better pricing that wouldn't be permitted as an acceptable execution method. Just thinking about it, it can vary by market, by products, by a number of different factors that one execution method, one that we haven't thought of now, may actually be more efficient.

Just thinking off the cuff about some of the technological innovations that we're seeing with virtual currencies and block chain technology, one would think that such technology or something similar to that type of technology could find its way into the execution of derivatives transactions. So, I guess to an extent, disincentives innovation that would allow for improved execution methods that may actually lead to more transparency, easier oversight for regulators. I definitely feel like anything that could restrict any of this type of innovation would certainly be a concern.

Julia**:** **The proposed alternative to the swaps trading framework is extensive, and it ranges from the focus on proficiency of market participants to increasing the flexibility of execution. Out of the various different proposals, which changes do you think are the most realistic and will have the greatest impact?**

Jeff: I'll start off by saying I do think that the changes in the whitepaper are intended to operate as a package; I think Commissioner Giancarlo makes that point very clear. That said, the change that will probably have the greatest impact would be permitting the more flexible execution methods, allowing other execution methods could help with market fragmentation issues, liquidity issues, and wouldn't stifle innovation, and I think a number of other fixes that are referenced throughout the whitepaper could see some improvement, based on allowing for more flexible execution methods.

I also think it's realistic to expect to see some change on this front as Europe and the SEC in the United States have indicated more flexible execution methods, so harmonization with other rule sets could help to drive that change.

I think another issue that the CFTC should consider and re-examine, and has mentioned in the whitepaper, has to do with the made available for trade (or what's known as the MAT process). Under the current rules, SEFs and DCMs can make a swap available to trade and thereby the bind the market participants to execute those swaps under SEF for

DCM simply by self-certifying that those swaps to the CFTC. This is a process that's served the futures market very well over the years, but the CFTC in this case doesn't need to follow a process for the determination, and the swaps market, as is highlighted throughout the whitepaper, is different than the futures market; it's a global market, there's fungibility between contracts, and I recognize that the industry certainly has resource constraints that have been highlighted over the years, but it strikes me that the CFTC would want greater oversight over this process that would have a binding effect on market participants and how they can execute swaps.

Julia: **Is there a recommendation in the proposed pro-reform agenda that you find particularly surprising or even problematic?**

Jeff: That's a great question. I think one of the surprising recommendations in the agenda was the proposal to raise the standard of professionalism for market personnel. Included in discussion within the paper is a requirement to take exams like the Series 3, or the Series 7 or other types of proficiency exams, and those requirements, depending on who they're placed on and how they're implemented, or if they're implemented, could prove to be burdensome for certain market participants. We've seen in other spaces such as the introducing broker space after swaps were introduced, a number of burdens with respect to exam taking and taking the Series 3 and, after consideration, the agency lifted those requirements. I think the reason that this particular aspect is surprising is I think folks that maybe don't…from an outside perspective that look at the whitepaper may view it as a rollback, but this particular provision (and some of the others) clearly is not a rollback; this would be a more restrictive requirement.

Overall, as with any of the rules, and any of the suggestions, and any of the changes, the rules should be implemented in a manner where they carefully consider the costs and consequences on the market participants.

***Julia*:** **Market participants and groups, such as ISDA for instance, have already expressed their support of the publication of this whitepaper. Do you expect regulators will revisit the SEF rules as a result of the recommendations and opinions expressed in this whitepaper and, if so, what is the likely process to follow?**

Jeff: I do think they're going to revisit the rules. I think CFTC chairman Massad has already said in testimony and in some of his speeches that even looking at the SEF rules he acknowledged that some fine tuning of the rules may be necessary and may occur. So I think from that perspective I do think the leadership at the CFTC, chairman Massad and certainly some of the other commissioners, see it as an important agenda item in the upcoming year and maybe into the future to fix some of those issues.

I think we could see, as far as what the process entails, I think we're already seeing with the whitepaper and some of the suggestions, I think discussions with market participants, we've seen roundtables where operators of swap execution facilities, market participants that use swap execution facilities, and others, have been invited to talk and discuss certain issues with the rules and what they're seeing in the markets.

I think we could see a rule proposal; a proposal that maybe amends some of those rules and that would go out for public comment and solicit feedback, but I think we've also seen and certainly over the last five or so years, almost five years since Dodd Frank and since the rules have been implemented, that there many ways to tweak the rules. We've seen probably hundreds of no action letters, we've seen interpretations, we've seen other agency guidance come out that helps to provide the market with some certainty and ideas about how the agency views certain rules.

Julia: **Great. Thank you Jeff for speaking with us today.**

So it seems regulatory reform will continue to evolve including more debate and possible tweaks in the near future.

I'm curious if you, our listeners, think that there will be a softening of derivatives regulation in the near future? In fact, we're running a quick and anonymous survey on this very topic, so please tell us what you think via our Podcast Notes page; you can see the link for the survey very clearly there.

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