

The CFTC's Implementation of Financial Market Reform: Progress and Legal Challenges

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WestLegalEdcenter Webcast
June 24, 2014

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I. Unregulated Swaps and the Financial Crisis



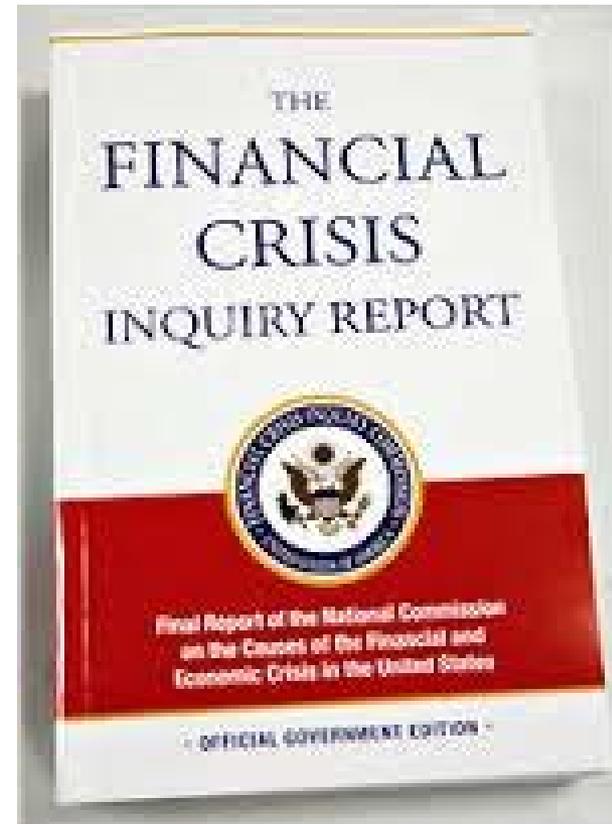
Unregulated Swaps Markets

- Swaps markets developed in the 1980s.
- Threshold legal question was whether swaps were futures contracts and therefore unlawful to trade except on a regulated futures exchange.
- Through the 1980s and 1990s, the CFTC issued policy statements and regulations exempting various types of swaps from CFTC regulation.
- The Commodity Futures Modernization Act of 2000 (CFMA) was intended to provide “legal certainty” to the swaps market. Swaps bilaterally negotiated between “eligible contract participants” were excluded from CFTC jurisdiction under the Commodity Exchange Act (CEA). The CFMA also excluded energy swaps traded on an electronic trading facility.



Unregulated derivatives were considered a cause of the financial crisis

- The Financial Crisis Inquiry Commission attributed the crisis to:
 - failure of regulation and supervision
 - failure in corporate governance and risk management
 - excessive borrowing, risky investments, and lack of transparency
 - collapse of mortgage-lending standards and the mortgage securitization “pipeline” accelerated the crisis
 - **lack of regulation of over-the-counter derivatives**
 - failures of credit rating agencies
 - the Government was unprepared and the response was inconsistent.
- Other possible causes were cited by others.





G-20 Commitment to Strengthen the Regulation of Derivatives

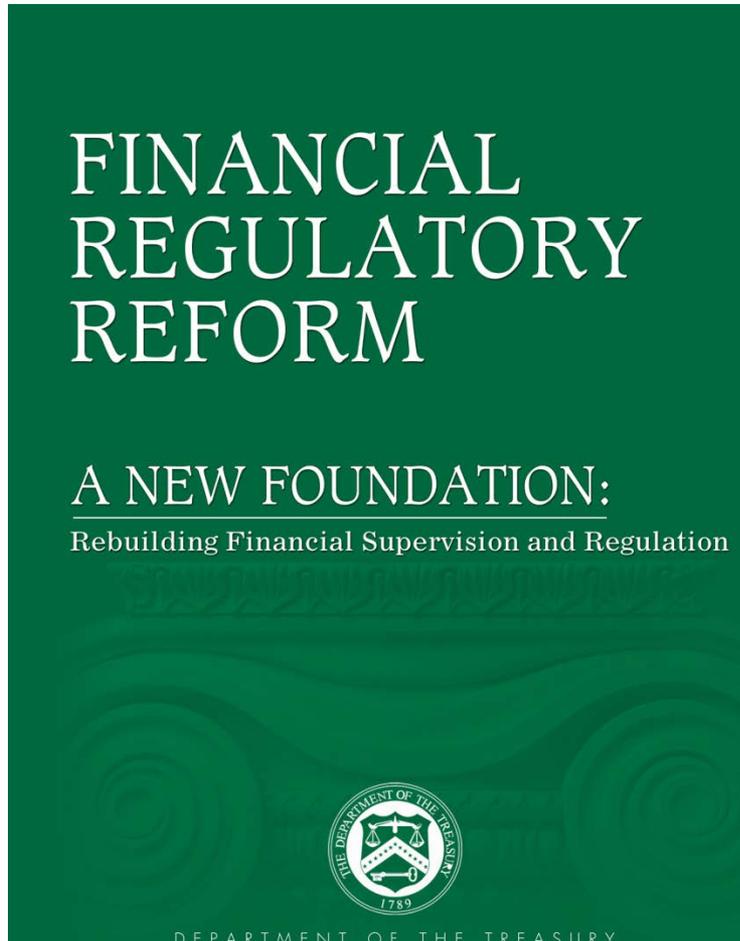


“We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage. . . .

“Improving over-the-counter derivatives markets. All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”

--Leaders' Statement, Pittsburgh, Sept. 2009

Administration Proposal for Regulatory Reform

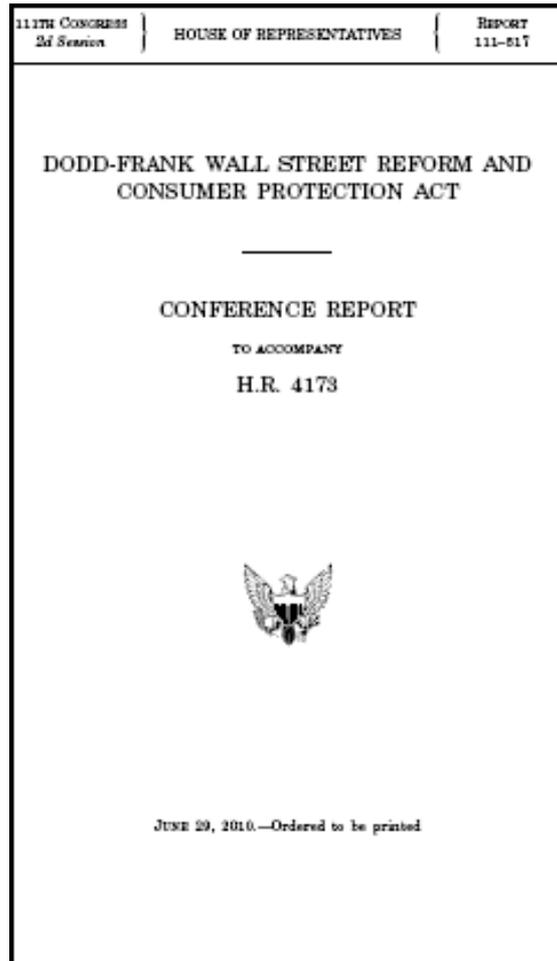


- Promote robust supervision and regulation of financial firms
- **Establish comprehensive regulation of financial markets**
- Protect consumers and investors from financial abuse
- Provide the government with the tools it needs to manage financial crises
- Raise international regulatory standards and improve international cooperation

II. The Dodd-Frank Act



Dodd-Frank Act – July 21, 2010



- 16 titles covering all aspects of financial markets and regulation, including:
 - Financial stability and designation of systemically important nonbank financial companies and infrastructure;
 - Resolution of systemically important companies
 - Consolidation of banking regulators and expansion of authorities
 - Regulation of hedge fund advisers
 - Insurance
 - **Regulation of swaps (Title VII)**
 - Enhanced investor protection and SEC authorities
 - Consumer financial protection
 - Mortgage reform
 - Amendments to the Federal Reserve.

III. Title VII of the Dodd-Frank Act: Swaps Regulation



Objectives of Swaps Regulation

- **Reduce systemic risk and protect market integrity:**
 - Regulation of market participants
 - Transparency and centralized risk mitigation
 - Regulation of markets
 - Speculative position limits
 - Enhanced enforcement tools
 - Cross-border reach
- **Preserve ability of commercial entities (“end users”) to hedge their commercial risks.**
- **CFTC regulates “swaps”; SEC regulates “security-based swaps.”**
 - Swaps: commodities; energy; FX; interest rate; broad-based security indexes (e.g., broad-based equity indexes, index credit default swaps).
 - Security-based swaps: single-name and narrow-based equity and credit default swaps.

Regulation of Market Participants

- Reduce risks presented by swap dealers and other firms with a large swaps business or counterparty exposure (“major swap participants”) through:
 - Registration
 - Capital and margin requirements.
 - Business conduct standards
 - Risk Management Programs
 - Recordkeeping
 - Reporting
 - Back office
 - Market conduct/disclosure
 - Additional conduct standards for swaps with “Special Entities.”

Regulation of Markets

- **Clearing mandate for “standardized” swaps.**
 - CFTC to determine whether clearing is mandatory for a swap.
 - Non-financial end-users that enter into swaps to hedge or mitigate commercial risk are excepted from the clearing requirement.
- **Execution mandate.**
 - Swaps required to be cleared must be traded on or through a regulated exchange or swap execution facility (SEF), unless no exchange or SEF makes the swap available to trade.
- **Transparency: reporting and recordkeeping.**
 - All swaps (cleared and uncleared) must be reported to a swap data repository.
 - Real-time public reporting: “as soon as technologically practicable.”
- **Margin requirements for uncleared swaps.**

Regulation of Markets: Infrastructures

- **Derivative Clearing Organizations (DCOs)**
 - Registration
 - Core Principles: Financial resources, risk management, margin requirements, settlement procedures, treatment of funds, default rules and procedures, rule enforcement, system safeguards, reporting, recordkeeping, public information and disclosure, information sharing, governance, antitrust considerations.
 - Additional requirements for systemically important derivative clearing organizations (SIDCOs). (Title VIII).
- **Swap Execution Facilities (SEFs)**
 - Registration
 - Core Principles: Compliance with rules, swaps traded must not be readily susceptible to manipulation, monitoring of trading, position limits, financial integrity of transactions, emergency authority, timely publication of data, financial resources, system safeguards, antitrust considerations, recordkeeping and reporting, chief compliance officer, annual reports.
- **Swap Data Repositories (SDRs)**
 - Registration
 - Core Principles: Data collection and maintenance standards; acceptance, confirmation, maintenance and access to data, protection of privacy, antitrust, governance.
- **Designated Contract Markets (DCMs).** Can trade swaps.
- **Foreign Boards of Trade (FBOT).** Registration required for a FBOT that provides direct access to persons located in the U.S.

Strengthened Enforcement Authority

- **New anti-manipulation authority**
 - Based on SEC Section 10(b) standard.
 - Often referred to as “fraud-based” anti-manipulation authority.
 - Additive to existing anti-manipulation authority in the CEA.
 - Similar to anti-manipulation authority recently provided to FERC and Federal Trade Commission.
- **New disruptive trading practices authority prohibits—**
 - Violation of bids or offers.
 - Intentional or reckless disregard for the orderly execution of transactions during the closing period.
 - “Spoofing” (bidding or offering with the intent to cancel the bid or offer before execution).
- **New whistleblower authorities and fund**
- **“Eddie Murphy” provision—**prohibits use of non-public government information prior to official release.



Limits on Speculative Positions

- **Futures and options.** Dodd-Frank directed the CFTC to set position limits for futures contracts and options on futures for energy, metals, and agricultural commodities “as appropriate” and in accordance with the standards in the Commission’s pre-existing authority to set position limits.
- **Economically equivalent swaps.** Dodd-Frank required the CFTC to simultaneously set position limits for swaps that are economically equivalent to the futures and options contracts for which it sets any new limits.
- **Aggregate limits.** In setting limits, CFTC must set limits on the spot month, individual months, and aggregate limits on all months combined. The Commission also must set aggregate limits across all contracts based on the same underlying commodity.
- **Bona fide hedging transactions are exempt from limits**
- **CFTC initial rule vacated**
 - In 2011, the CFTC adopted new rules imposing speculative position limits on 28 futures contracts (including various energy commodities) and economically equivalent futures, options and swaps.
 - Rule was vacated in September 2012 by U.S. District Court.
- **In November 2013, CFTC re-proposed position limit rules.**

Cross-Border Provisions: CEA §2(i)

- Provisions of the CEA relating to swaps shall not apply to activities outside the US unless those activities:
 - “have a direct and significant connection with activities in, or effect on, commerce of the United States”; or
 - “contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA].”

IV. CFTC Implementation of Dodd-Frank

CFTC Rule Writing Nearly Complete

- **CFTC has completed 65 final rules, orders, and guidance documents**
- **Swap Dealer registration: 102 Swap Dealers provisionally registered**
- **Clearing requirement:**
 - Mandatory clearing for interest rate and index credit default swaps (CDS)
 - Exceptions for commercial end users, small banks and inter-affiliate swaps
- **Trade execution requirement:**
 - 22 Swap Execution Facilities (SEFs) temporarily registered
 - Mandatory trading on SEFs or exchanges for certain interest rate and index CDS
- **Transparency and reporting requirements:**
 - 4 Swap Data Repositories (SDRs) provisionally registered
 - Reporting of all swaps underway – approx. \$400 trillion in notional value reported
- **New anti-manipulation rules**
- **Guidance on application to cross-border activities**



Swap Dealers and MSPs

- **Registration required when entity reaches a threshold of swaps activity or exposure**
 - For swap dealers, \$8 billion notional or \$25 million notional with special entity counterparties (\$8 bn notional for utility special entity counterparties per no action relief)
 - For MSPs, various exposure levels
 - Registration began December 2012
- **Business Conduct Standards**
 - Standards for dealing with counterparties: verification of counterparty eligibility, confidential treatment of counterparty information, disclosures of material risks and conflicts of interest, know your customer suitability requirements, requirements for SDs/MSPs acting as advisers or counterparties to special entities, end-user exception documentation.
 - “Internal Business Conduct Standards”: Risk management program, portfolio compression and reconciliation, chief compliance officer, recordkeeping, monitoring, diligent supervision, conflicts of interest prohibitions.

Clearing Requirement and Exceptions

- **All swaps subject to mandatory clearing must be cleared unless an exception or exemption exists.**
 - **End user exception**
 - Must be a nonfinancial entity
 - Using swaps to hedge or mitigate commercial risk
 - Notifies the Commission how it generally meets its financial obligations associated with entering into non-cleared swaps
 - **Co-operative exception**
 - **Inter-affiliate exception**
 - **Treasury exception**
 - CFTC has used its discretionary authority to exempt small financial institutions (small banks, savings associations, credit unions, farm credit institutions with assets less than \$10 billion).



Trade Execution Requirement

- Swaps required to be cleared must be traded on a futures exchange (DCM) or registered swap execution facility (SEF), unless no SEF or DCM makes the swap available to trade.
- Trade execution must be by order book or request for quote to a minimum number of market participants.
- Swaps not required to be traded on a SEF may be traded on a SEF (“permitted transactions”).
- Any facility that permits “multiple participants to execute or trade swaps by accepting bids and offers made by multiple participants” must register as a SEF.
- SEFs have “made available to trade” certain interest rate and index CDS that are subject to the mandatory clearing requirement. These swaps are subject to the trade execution requirement.



Reporting and Recordkeeping

- **Reporting**
 - Virtually all swaps must be reported to a swap data repository.
 - CFTC regulations specify the counterparty that must report.
 - Each swap must have a unique swap identifier.
 - Each counterparty must have a unique “legal entity identifier.”
 - Reporting party must report “creation data” when a swap is executed and “continuation data” over the life of the swap.
 - Real-time reporting of key characteristics (type of swap, price, volume) within specified time frame (general standard is “as soon as technologically practicable”).
- **Recordkeeping**
 - End users must keep full, complete, and systematic records of all data pertaining to swaps during the life of the swap and 5 years thereafter.

Cross-Border Guidance (July 2013)

- **Definition of “U.S. person”**
 - All swaps with a U.S. person are subject to Title VII requirements.
 - Foreign branches and guaranteed and conduit affiliates of U.S. persons may also be subject to Title VII requirements.
- **What counts**
 - How U.S. and non-U.S. persons should count swaps for purposes of reaching SD/MSP registration thresholds, including how to aggregate affiliate holdings.
- **Entity-level and Transaction-level requirements**
 - Which Title VII requirements apply to which entities (U.S. and non-U.S.) and transactions (with U.S. and non-U.S. counterparties).
- **Substituted compliance**
 - When non-U.S. persons may comply with rules of their home jurisdiction as a substitute for compliance with Dodd-Frank rules.



Cross Border: International Harmonization and Issues

- EU, US and other international market regulators have been meeting regularly and working closely together.
- EU and CFTC issued common “Path Forward” document in July, 2013.
 - Goal is to avoid conflicts of law, inconsistencies, and legal uncertainty.
 - Appropriate to defer to another regime when justified by the quality of the other regulatory and enforcement regime (“substituted compliance” in the US; “equivalence” in the EU). Agreement on “outcomes based” approach.
- In Dec. 2013 CFTC issued substituted compliance determinations for certain entity-level requirements in 6 jurisdictions and for certain transaction-level requirements in the EU and Japan.
- Major outstanding issues
 - Mutual recognition of trading facilities and clearing organizations
 - Privacy laws may prevent sharing and cross-border reporting of trade data
 - Differences in regulatory standards, timing of implementation



Rulemakings Not Yet Completed

- Capital requirements for non-bank swap dealers and major swap participants
- Margin for uncleared swaps
- Position limits (proposed)
- Revised de minimis standard (same as general de minimis level) for utility special entities (proposed)

V. Judicial Review of CFTC Rulemakings

Judicial Challenges

- Most of CFTC regulations have gone into effect without judicial challenge.
- To date, the CFTC's position limits rule issued in November 2011 is the only regulation that has been overturned.
- Judicial opinions have applied traditional doctrines regarding statutory interpretation, administrative law, deference to agency decisions.
- Forecasts that the D.C. Circuit would use cost-benefit analyses to apply a heightened standard of judicial review or as a pretext to overturn CFTC rules have not been accurate.



Investment Company Institute (ICI) v. CFTC (rescission of CPO exclusion)*

- Plaintiff challenged the Commission’s rule rescinding the exclusion CFTC previously granted from status as a commodity pool operator (CPO) for registered investment companies (e.g., mutual funds) regulated by the SEC. Plaintiffs challenged the Commission’s rationale for the rule and consideration of costs and benefits.
- **Court of Appeals holding:**
 - The standard to be applied to an agency changing course is that the new policy is permissible under the statute, that there are good reasons for it, and that the agency believes it to be better. Court found the CFTC’s rationale “clears this low bar.”
 - Standard of review for cost/benefit considerations is “whether the [agency] decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.”
 - The CEA does not require CFTC to quantify costs and benefits. The statutory requirement to consider costs and benefits “does not require agencies to measure the immeasurable.” The statute does not obligate the agency to engage in “rigorous, quantitative economic analysis.”
 - Basic APA standard of review is whether the rule is “arbitrary or capricious.”
 - Appropriate to defer to agency expertise as to specific regulatory definitions.

****720 F.3d 370 (D.C. Cir. 2013)***



*ISDA v. CFTC** (position limits)

- **Plaintiff's claim:** The CFTC had failed to meet the “unambiguous” requirement in CEA § 4a(a)(1) that the CFTC determine that position limits were necessary to “diminish, eliminate, or prevent” the undue burdens on interstate commerce that may result from excessive speculation in any commodity.
- **Commission position:** The statute required the Commission to impose position limits with the specified time limits and that predicate findings were not required.
- **District Court holding:** The court disagreed with both parties' arguments. It held that the Dodd-Frank Amendments to the CEA were ambiguous as to whether any findings were necessary prior to the Commission imposing position limits. Finding the statute ambiguous, the court held the Commission's position was not entitled to deference. It vacated the rule and remanded to the agency “so that it can fill in the gaps and resolve the ambiguities.” The court found it unnecessary to address plaintiff's other arguments, such as its challenge to the Commission's consideration of costs and benefits.

**887 F. Supp. 2d 259 (D.D.C. 2012)*



Bloomberg v. CFTC* (DCO margin for swaps)

- Plaintiff challenged CFTC's final rule establishing minimum liquidation times a DCO must use in determining margin requirements for swaps and futures. Plaintiff argued the Commission provided insufficient notice of the rule provisions, that the rule was arbitrary and capricious, and the Commission provided only a "superficial" discussion of costs and benefits. Plaintiff also filed a motion for a preliminary injunction, claiming that implementation of the rule would cause irreparable harm, due to market participants trading "swap futures" rather than swaps in order to be able to trade swaps with lower margin requirements for futures than for swaps.
- **District Court holding:**
 - The plaintiffs lacked standing.
 - The plaintiff had not demonstrated that any DCO had adopted a lesser liquidation time for swap futures than for swaps, or was imminently about to do so. Therefore the plaintiff had not sustained any injury.

****2013 U.S. Dist. LEXIS 80275 (D.D.C. 2013).***



SIFMA et. al. v. CFTC (cross-border) (pending)

- Plaintiff's claim:
 - The CFTC's cross-border guidance is a binding rule that was not promulgated in accordance with the APA.
 - The Commission failed to consider costs and benefits as required by the CEA.
 - 14 Rulemakings should not have cross-border application because:
 - CFTC did not respond to comments regarding cross-border application during the rulemaking process.
 - CFTC did not consider cost-benefit analysis of cross-border application in drafting them.
 - The SEF rule violates the APA because it is arbitrary and capricious as it requires foreign platforms to register if they provide access to US Persons or US-Located Persons (per staff advisory).
 - Seek invalidation of guidance and application of the 14 rules to cross-border activities.
- Commission defense:
 - Guidance is not binding and therefore is not a rule subject to APA.
 - Dodd-Frank does not require a rule.
 - Rules have cross-border application under 2(i), not because of Commission rulemakings.
 - Plaintiffs lack standing as they have not shown harm yet.



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See also, Dan M. Berkovitz, “The CFTC’s Implementation of Financial Market Reform: Progress and Legal Challenges,” *Futures and Derivatives Law Report*, Vol. 34, Issue 4 (April 2014).



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