

WEEKLY REGULATORY AFFAIRS UPDATE
July 7, 2016

CFTC Regulatory Developments

CFTC Regulations

CFTC Position Limit Update

- ***CME and ICE Meeting with the CFTC:*** During separate meetings, it was made clear to both CME and ICE during the meetings with staff overseeing the position limit rule making process, that the CFTC's Position Limits Proposal from 2013, along with the proposed amendments in the Supplemental Position Limits Proposal 2016, will be finalized as generally as proposed. This would not be good news due to the increased reporting requirements and limitations on what is considered a *bona fide* hedge under CFTC Federal rules as well as the new requirements the exchanges will have to implement. **Redacted - First Amendment**

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Basel III Leverage Ratio

- ***Basel III Leverage Ratio*** – The Basel Committee on Banking Supervision (“BCBS”) is seeking further comments on the Leverage Ratio issue. Because of the concerns for end-users to get access to clearing, BP is working with CMC on an end-user survey to be submitted to the Basel Committee. **Redacted - First Amendment**

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CFTC Policy:

Summary of the CFTC June 27 Market Risk Advisory Committee (“MRAC”) – Focus is on the Potential Default of a Central Clearing Member

➤ Key Takeaways

- The MRAC’s Central Clearing Counterparty (“CCP”) Risk Management Subcommittee recommended the creation of a global directory of all interested parties to a CCP default, and advocated for simultaneous default drills.
- CME and ICE said that the document underlying the *Uniform CCP Terminology for Default Management Auctions* is a good first step to ensure better coordination during the auction process.
- CME, ICE and LCH Clearnet stated that regulatory capital requirements (i.e. leverage ratio) will disincentivize CCP’s from porting customer funds and that regulatory relief is warranted.
- CFTC staff said that the CFTC will provide guidance on clearing organization recovery rules by the end of the year.

➤ Summary

- **Chairman Massad** stated that resolution plans for global systemically important banks (“G-SIBs”) are important because G-SIBs have FCM subsidiaries that are CCP members or provide custodial or settlement bank services, and has the potential to impact clearinghouse resiliency.
- **Commissioner Bowen** said that since it is highly likely that the default of a significant clearing member would occur in an environment where multiple CCPs and clearing members are impacted, CCP coordination just makes sense. Further, she stated that there is no question that it would be in everyone’s best interest for CCPs to consider beforehand how processes for dealing with such an event would work. For instance, their auction processes, porting processes, and their practices to staff seconded traders could all be better aligned to bring maximum transparency and clarity to market participants during a potential default.
- **Question: How can CCPs better coordinate the scheduling of traders who help with the default management process so that trading desks are not over-tasked during a time of crisis?** CME said clearing members must submit their traders to a CCP’s procedures, especially during the auction process. CME and ICE have already coordinated on a rotation of traders. ICE stated that once the trader is on the default management committee, it must recognize that they are now acting on behalf of the CCP.
- **Question: Are there other ways that CCPs can coordinate more effectively in order to mitigate the effect of a default of one or more significant clearing members?** CME said that better coordination between G-SIB regulators and CCPs will allow for information sharing on marketplace stresses and the viability of the CCP mechanism. Coordination will put the CCP in a better position to act in a default situation. Preplanning and standardizing tools for inputs and outputs with regard to the porting of customers will be helpful. The industry must work together so regulatory capital requirements do not create the potential for refusal, making porting

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problematic. The leverage ratio and its treatment of customer margin will be problematic in times of stress and should be addressed. Americans for Financial Reform chimed in that it is hard to believe banking regulators will not be willing to work toward easing capital rules in emergency situations. Advanced coordination helps, but fundamentally, clearinghouse solvency is more important.

- **Question: Are there any operational, legal, logistical, or other barriers to CCP coordination?** CME said it maintains MOUs with various CCPs abroad and is comfortable in sharing information about positions and exposures to identify an opportunity to net or liquidate those positions in times of stress. CME also stated that the industry must ensure CCPs have protection to share information during crisis management if necessary, beyond the bounds of an MOU. The resolution and recovery process should not be too prescriptive. ICE stated that currently the CCP risk management practice requires holding default resources at a minimum of cover two (to cover the default of its two largest clearing members). At the end of the waterfall, the CCP will wind down as a last resort and consider variation margin gains haircutting (“VMGH”). Blackrock stated that use of VMGH should never be an option in the recovery or resolution process because these funds belong to non-defaulting customers. CCPs are for-profit companies benefitting from the clearing mandate and additional transparency is needed in a CCPs loss absorbing capacity and its margin methodologies. Buy-side customers should have the option to pay additionally for the cost to use cleared products or to use other hedging instruments.

Summary of CFTC and FDIC Staff Presentation on CCP Resolution

- The timing of entry into resolution should be a discretionary decision and not automatic. Resolution should be entered when recovery measures are exhausted and have failed to return the FMI to viability and continuing compliance with applicable legal and regulatory requirements, or when such measures are not reasonably likely to return the FMI to viability within the timeframe required to enable continued compliance with applicable legal and regulatory requirements (i.e. despite planning, there was a default).
- Resolution authorities have the power to: (i) enforce unexhausted contractual obligations of participants to meet cash calls or make further contributions to a guaranty fund; (ii) enforce unexhausted obligations of participants to accept positions of the defaulting participant; (iii) write down equity of the FMI, (iv) reduce the value of any gains payable by the FMI to participants (VMGH); and (v) tear up contracts.
- Resolution authorities may write down IM of participants only where IM is not remote from insolvency and where consistent with the legal framework and FMI rules.
- Systemically important clearing organizations: (i) must maintain viable plans for recovery or orderly wind-down necessitated by uncovered credit losses, liquidity shortfalls, and other types of risk; (ii) must maintain procedures for providing the CFTC and FDIC with information needed for resolution planning; and (iii) must have been consulting with stakeholders regarding the development of recovery plans and proposed rule changes.

CFTC Legislation

- **New Derivatives Bill: To Improve Federal Oversight of Risky Derivatives Trading and Protect Taxpayers**
 - The Bill was introduced by Senators Warren (D-MA) and Warner (D-VA) and Congressman Cummings (D-MD). While the bill does not appear to be focused on end-users, there are provisions in the bill that will almost certainly increase the costs of derivatives for end-users and that could be of concern.

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- **Increased FX Transaction Costs:** The Bill would treat foreign exchange (“FX”) forwards and swaps, which are currently exempt from the definition of “swap,” in the same manner as all other swaps. This means that FX forwards and swaps would be subject to all Dodd-Frank rules, including uncleared margin, clearing and trade execution requirements. For end-users, the general view is that the Bill would likely increase the costs of these FX transactions.
- **Elimination of the Inter-Affiliate Margin Exemptions and Increased Capital Requirements for Swap Dealers:** The Bill would also eliminate the inter-affiliate margin exemptions that have been promulgated by the CFTC and banking regulators. Eliminating the inter-affiliate margin exemptions would effectively require swap dealers to post double margin (or more) for their swaps – costs that are likely to be passed on to end-users. Further, the Bill would increase the amount of capital that would need to be held by swap dealers by eliminating closeout netting. An internal analysis needs to be done by BP Legal but it may also be a concern that the bill strikes the provision of the bankruptcy code that enables the non-affected party in a transaction to terminate their derivatives outside of bankruptcy proceedings.
- **CFTC Cross-Border Authority Expanded:** The cross-border scope of the CFTC’s authority would be expanded by the Bill, which would amend the CFTC’s Commodity Exchange Act (“CEA”) so that subsidiaries outside the U.S. that are majority-owned or controlled by a U.S. financial entity would be subject to the CFTC’s jurisdiction. This means that end-user transactions with non-U.S. entities that are not otherwise subject to Dodd-Frank would now become subject to Dodd-Frank simply because they are majority-owned by a U.S. person. There is a substituted compliance provision; however, the thresholds set out for granting substituted compliance appear quite high, making it unlikely to ever come into play and therefore requiring compliance in multiple jurisdictions and making harmonization even more difficult.
- **Increased Fines for Violation of CFTC’s Commodity Exchange Act (“CEA”) and Implementation of User Fees:** The Bill would increase the maximum fine for individual violations to \$1,000,000 and extend the statute of limitations for CEA violations from five years to ten years, and would assess user fees on various CFTC registrants and require the CFTC to perform a study on clearinghouse risks.
- **Outlook for Moving Forward:** If the Bill does not move forward in the House or Senate, it seems that there is a realistic possibility that the bill could move the goalposts in the wrong direction for CFTC Regulations and Democratic legislation relating to the regulation of derivatives, whether under President Obama or a President Clinton, if elected.

General Regulatory Developments

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- Cellulosic waiver credits