The Dodd-Frank Act and the Changing Regulatory Landscape for Derivatives Trading in the United States

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Introduction: It is an honor to be here today. I would like to thank the Exchange for asking me to speak at this prestigious conference. I'm particularly pleased because I have been working with Exchange staff over the last 6 moonths to update the Exchange's rulebook, a truly monumental task.

And so let me begin. Regulation in the US is in great flux as the result of a piece of legislation known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, or Dodd-Frank for short.

I'm going to give you a brief history and then describe some of the features of the Act that involve the futures markets and those who trade futures.

I. Brief history of the swaps market

Swaps trading was created in the early 1990s

It initially involved only banks trading interest rates and forex among themselves.

As liquidity grew, users of the market expanded to include:

Businesses seeking hedge instruments with **customized terms** to meet their business needs. This was in contrast to the standardized terms in futures contracts. Dodd-Frank calls these businesses **end users**.

Hedge Funds (in my comments today this term is meant to include commodity pools) looking for liquid investments to trade and also wanting to hedge positions in very liquid markets.

Sovereign Funds with the same purpose.

Types of swaps grew from the plain vanilla (exchange of fixed rate for floating rate) to highly complex instruments.

Banks took the other side of each trade. No transparency with respect to the prices of the swap.

Result: an unregulated market which today is amounts to a huge $633 trillion globally.

II. **The Commodity Futures Modernization Act of 2000**

In the late 1990s, the CFTC decided to examine the swaps market because of its growing size. In the futures markets size often brings risk.

Dealers in swaps (mostly large banks, Wall Street brokerage houses and a trade association (the International Swaps and Derivatives Association known as (ISDA)) lobbied Congress to prohibit the regulation of swaps and other non-futures derivatives.

The resulting Act, The Commodity Futures Modernization Act , was a dream for those who favored deregulation.

It forbade the SEC from regulating the swaps markets,

It allowed the CFTC to limit swaps market users to **Eligible Contract Participants** and to permit swaps trading on electronic markets but the Commission could do little else.

For those unfamiliar with the term ECP, here are some examples:

a financial institution such as a bank, an insurance company, a mutual fund, a commodity pool with AUM of more than $5 million, a pension plan, a broker-dealer, an FCM or an **individual who has amounts invested of at least $10 million**.

III. **Events of 2007-2008**

During this period the use of Credit Default Swaps as well as mortgage-backed securities almost brought down the US financial markets.

A CDS acts like a form of debt-default insurance. The buyer of the CDS makes a series of payments (known as the CDS fee or spread) to the seller. In exchange the buyer will receive a payment (usually the face value of the loan) if there is a loan default.

At first only persons holding a loan purchased CDS protection. However, a highly liquid market developed. It even included persons who did not hold a loan instrument and who did not have a direct insurable interest in a loan. In this case the swap was called a naked CDS and the swap participants were speculators.

By the end of 2007, the outstanding amount of credit default swaps was $62.2 trillion, a not inconsiderable sum. (Source: Wikipedia)

As the result of the market disruption in this period when mortgage backed securities went into default and CDSs were triggered, one very large investment house (Lehman Brothers) was allowed to go into bankruptcy and two well-known brokerage firms (Baer Stearns and Merrill Lynch) were forced to allow themselves to be bought by other financial companies.

In addition, the writer of most of the CDS products, an insurance company by the name of AIG (American International Group), needed a massive infusion of capital as it had to pay out on the CDS contracts it had written.

IV. **Adoption of Dodd-Frank Act**

A massive piece of legislation with 16 titles in 2300 pages, it was passed by Congress in the middle of 2010. Dodd-Frank was enacted to protect the economy from banks considered "too big to fail" because these banks might take the economy into a freefall if they became financially unstable.

Also, because of the harm done by the CDS market, Congress took a long look at the enormous growth in the size of the swaps market. It decided that swaps trading also presented the opportunity for harm to the economy because, in the US, 5 Wall Street banks accounted for over 90% of all swaps trading.

In the words of one commentator, the purpose of Dodd-Frank was to change swaps trading from an "opaque bilateral market to something where there is some price transparency and a more open and automated market."

Of the 16 Titles, we are most interested in **Title VII**, which directs the CFTC and SEC to impose extensive regulations on swaps trading and swaps traders. The requirements of Title VII in particular are so complex that three years after the Act's passage, no more than 40% of the rules it requires have been adopted by the financial agencies, like the CFTC and SEC.

We begin with regulation of Swap Dealers and Major Swap Participant

A. **Dodd-Frank requires large actors in the swaps market to register and provide data to the federal government.**

Who is a Swap Dealer ? A person that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account or is commonly known in the trade as a dealer or market maker in swaps.

The CFTC has provided an **exemption** for persons who engage in a **de minimis** quantity of swaps trading. (**De minimis** means the person has traded swaps with **an aggregate gross notional amount of no more than $3 billion** in the prior 12 months. This is the most important definition. There are others we haven't time to discuss.)

The Definition of a Major Swap Participant (MSP)

Hedge positions in swaps do not count when determining whether a person is an MSP. An MSP is a person which maintains a **substantial position** in swaps in any **major swap category**. I'll define the terms **substantial position** and **major swap category** in just a moment.

Why is a Major Swap Participant being regulated? Let me offer two of several reasons:

1. It's outstanding swaps create **substantial counterparty exposure** that could seriously affect the financial stability of the US banking or financial system; **and**

2. It's a financial entity that is **highly leveraged** in proportion to the amount of capital it holds and maintains a **substantial position** in outstanding swaps in any major swap category.

Duties of Swaps Dealers and Major Swaps Participants: There are 5.

1. **Monitoring trading to prevent violations of speculative position limits (which we will discuss later). This includes:**

diligently monitoring trading;
implementing an **early warning system** to avoid exceeding spec limits;
testing its procedures to make sure it don't exceed spec limits;
documenting compliance with spec limits quarterly; and
auditing procedures annually.

2. **Establishing risk management procedures for its daily business.**

Take into account **market** risk, **credit** risk, **liquidity** risk, **foreign** currency risk, **legal** risk, **operation** risk, **settlement** risk and an all-purpose category for **all other <u>relevant</u> risks**.

Swaps Dealers and Major Swaps Participants must monitor traders throughout the day for **compliance with trading limits**, and require their traders to follow procedures for executing and confirming trades. They must also **diligently supervise** traders and **separate** traders from risk management unit.

3. **Disclosing** to the CFTC and other regulators general information on its **trading, practices and financial integrity.**

4. Create internal systems to obtain the information to perform all required duties.

5. Refraining from acting in an anticompetitive way or in restraint of trade

What is a substantial position in the case of a Major Swap Participant?

This is a position where the MSP has a **daily average current uncollateralized exposure** of at least $1 billion in each specific category of swap ($3 billion for rate swap category.)

The other categories are **credit** swaps, **equity** swaps or **other commodity** swaps such as a swap based on a **physical commodity**.

In other words, **cleared swaps are excluded** because they are collateralized.

The definition of MSP has been designed to catch only the largest traders.

B. **Requirement that standardized swaps be cleared**

What are standardized swaps?

These are contracts in which the **buyer** is guaranteed to receive a specific grade and quantity of product delivered to a specific **location** on a specific **date**. The only non-standard term is the price. The **best example** is a futures contract.

The Commission with the assistance of the exchanges is determining what contracts are standardized and must be cleared.

What contracts do not fall under this category?

These are contracts with **customized** terms. For example, an airline may use a **special kind** of fuel, want a quantity that specifically **matches its needs** and want it **delivered** to a specific location at a specific **time** or **liquidated** at a special time. Customized contracts are generally traded by companies that are using the swap as a hedging tool.

What are contracts "unavailable for clearing"?

At least at this time, the CFTC is unwilling to force a Central Counterparty to clear a contract. If no CCP will clear it, then it must be executed bilaterally

and certain requirements will apply as to collateral that needs to be posted between the parties.

What are CCPs?

These are **Central Counterparties** or what we in the futures industry refer to as **clearinghouses**. These have been created to clear standardized contracts. Unlike in the futures markets, which began with each exchange having its own clearing house, there is an expectation that swaps may be cleared on CCPs unaffiliated with the exchange on which the swap is executed.

Swaps are deemed to be riskier than futures and therefore the margin deposited with the CCP will be higher than for futures. While **futures** clearing houses set margin based on one day's VaR (Value at Risk), margin for swaps will be set at 5 days' VaR, although the industry is protesting very loudly.

C. **Cleared contracts must be executed on an SEF (Swaps Execution Facility)**

A **SEF** is a trading system or platform that provides an order book that

shows all the bids and offers **available** in the market; and
allows participants to enter bids and offers and **execute** swaps based on these bids and offers.

This is an enormous step away from the secretive bilateral market that has characterized swaps trading.

The CFTC just passed rules regulating SEFs on May 16, 2013. The Commission has not yet announced the effective date of the SEF rules.

One commentator (the Tabb Group) found the **following benefits** to requiring swaps to be executed on SEFS:

A **smaller** swaps market as a result of the cost of clearing;
A narrower in the **bid/ask** spread;
A decrease in the size of **commissions**;
Greater turnover **velocity**;
Smaller trade **position** size;
More standardized terms for swaps; and
Greater **migration** to the futures markets.

This last benefit has a new name. It's called **futurization.** Of course, not everyone is happy with it.

There are many groups talking about registering as SEFs. Please not that an existing exchange can also register to be a SEF.

D. **Requirement that all contracts whether cleared or not be reported to a Swap Data Repository (initials: SDR)**

Futures exchanges are required to report to the public throughout the trading day and at the close all trade activity, including bids and offers, execution prices and volume, taking place on their exchange. SEFs will have similar responsibilities.

But not all swaps will take place on an exchange or SEF. To make sure the regulators and self-regulatory organizations like the exchanges and the National Futures Association, known as NFA, get all information on all swaps executions whether on an exchange or transacted bilaterally, Dodd-Frank created the SDR.

An exchange may register to be an SDR or the SDR may be a stand-alone entity. All SEFs must report transactions executed on their facility to an SDR. For an Over-The-Counter (also called OTC) swap, most will involve at least one counterparty that is a Swap Dealer or a Major Swap Participant. The Swap Dealer or MSP then is obligated to report the transaction to the Swap Data Repository. There are also rules that apply where neither counterparty is a Swaps Dealer or Major Swap Participant.

Suddenly there will be light where there was darkness. The SDRs, as a group, will give the regulator a picture of who is trading in the different swaps markets, the size of their positions and any unusual activity that might suggest a risk to the US financial system.

There is an expectation that several companies will offer SDR services. One potential SDR is now suing the CFTC because the Commission has approved a rule of a CCP that also wants to serve as an SDR. This rule would allow them to require persons who clear using their Central Counterparty also to use their Swaps Data Repository. The party suing claims this is anti-competitive.

We've now talked about new registrants and new executing, clearing and reporting facilities. We now look at risk management tools addressed by Dodd-Frank.

E. **Other risk management tools**

i. **Speculative position limits, a term I mentioned earlier**

Currently, the CFTC sets spec limits for most of the ag contracts and the exchanges set position limits and position accountability limits (more flexible limits) for

all others. Dodd-Frank removed this responsibility from the exchanges and gave it to the CFTC for all but the financial futures markets. It also directed the Commission to impose spec limits on certain swaps.

What is a spec limit? It is the maximum position in a futures contract that may be held or controlled by a trader during the trading day or overnight.

Three types of spec limits are set for each contract: a limit on what can be held in the spot month, a limit on what can be held in a non-spot month and a limit for all months combined. Usually the individual month and "the all months combined" limits are the same and the spot limit is lower.

Spec limits are typically set in the physical markets, especially the agricultural markets and not in the financial markets.

Why are they used? Spec limits have been used since early in the 20th century, based on a theory that a trader may be able to corner or squeeze a market (in other words, **manipulate a market**) if it has a large enough position. Many academic and other research papers have failed to find that spec limits dampen volatility or prevent manipulation, even in the spot month, but Congress appears to want the CFTC to impose them.

Spec limits do not apply to hedgers.

Persons using the futures markets for hedge purposes are not required to comply with spec limits. The obvious reason is that the futures markets developed exclusively to give hedgers a mechanism to transfer risk. The regulators want to encourage hedgers to use the markets. The best way to do this is to promote an orderly market and this is what spec limits are supposed to do.

What is a hedge exemption? To avoid complying with spec limits, hedgers must receive a hedge exemption. In certain cases the Commission and in other cases the exchanges grant the exemptions.

In some cases this exemption gives them a **specific number** of contracts they may hold. In other words, they are bound by a position limit **related to their need** for a set number of contracts equal to the product they are hedging. In other situations, they receive a **blanket exemption** which, reportedly, some hedgers have used to take large spec positions.

With this background, let's look at the spec limit provision in Dodd-Frank:

It appears that the wording Congress used in writing the spec limit provision to the Act was unclear. The provision said that the CFTC was to establish spec limits Timing,on 180 days to adopt limits for certain energy product contracts and 270 days to adopt limits for certain agricultural contracts.

CFTC then wrote rules imposing spec limits on swaps and certain futures contracts (28 markets in all). Some of the ag markets already had spec limits set by the Commission, but the energy markets and swaps on the ags and energy markets previously had no limits.

The Commission thought **its mandate was clear** by the wording in the Timing section: It had been directed to impose limits on all contracts **except for financial futures and financial swaps** which are deemed to be very liquid and not likely to be manipulated. CFTC felt that its authority was so clear that it **did not have to determine** whether spec limits were necessary to **protect** the markets from manipulation.

A trade association representing users of futures markets sued in federal court. The **court held** that the use of the words, "**if necessary**," made it a requirement for the Commission to make a finding that spec limits were necessary.

The result: In April the Commission appealed the court's decision and, according to one Commissioner, will offer a new set of rules for Commission discussion perhaps as early as this June. No information is currently available on how these rules might differ from the last set.

ii. **Large Trader Reports**

These are not yet in place for swaps. Therefore, I will discuss how reporting works in the futures markets:

Reporting is the responsibility of the FCM not the trader. In other words, an independent third party submits the data.

Each contract has a reportable limit, even if it doesn't have a spec limit. If the trader has a net position that exceeds that limit, a report must be made to the CFTC before the opening of the market on the following trading day.

Reportable limits are **substantially lower** than position limits.

Here are some examples:

Spec Limit for **soybeans** in a single month is 15,000 contracts.
Reportable limit is 150 contracts.

Spec limit for **corn** in a single month is 33,000 contracts.
Reportable limit is 250 contracts.

One of the largest contracts traded on the Exchange, the **Eurodollar** contract has a Reportable Limit of 3,000 although it does not have a spec limit.

iii. **Reports relating to systemic risk**

The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC), headed by the Secretary of the Treasury. All major financial agencies are members.

The purpose of the FSOC is to monitor the economy for systemic risk caused by the failure of large **bank holding** companies or **non-bank financial companies**. Hedge funds are one example. To fall within their oversight, that is, to be **systemically significant**, a non-bank financial company has to have assets of at least $50 billion, eliminating most if not all hedge funds.

To assist the FSOC in its monitoring, the CFTC has developed two forms, Forms CPO-PQR and CTA PR, and the SEC has developed Form PF which have to be filled out by CPOs, CTAs and the managers of private hedge funds.

These forms request voluminous detail, especially from the largest **registrants**(and by registrants I mean CPOs, CTAs and hedge fund managers registered with the CFTC and SEC) as to their structure and holdings.

Here are some examples: The SEC and CFTC forms are similar in the data they request. Large registrants of both the CFTC and SEC generally fill out the SEC's Form PF. That is where I've drawn my examples:

Just to give you an idea of the depth of information they are requesting: the Form is 42 pages long!

Reporting is based on regulatory assets under management by the advisor (gross assets without subtracting any borrowings).

Directions are still incomplete, therefore assumptions may be used if explained on Form.

We turn to some examples. They request:

A **breakdown of assets** under management
A description of, including the size of, **derivatives** held
Details on which **investor groups** own interests in the fund:

(individuals—both US and non-US, broker dealers, insurance companies, pension plans, mutual funds, other hedge funds, and several other groups.)

The fund's monthly performance reported on both a gross and net basis and based on how it is reported to investors. (Note that the CFTC requires the use of a prescribed formula for calculating performance while the SEC does not.)

The percentage of assets used in **high frequency trading**

Information on the fund's liquidity

Results from VaR and other stress testing

The **first sets** of Forms have been filed by the required hedge fund managers, commodity pool operators and commodity trading advisors. Persons completing these Forms still have many questions that the two agencies are answering very slowly.

The **biggest question** is what the agencies plan to do with this information. Do they have the staff to review the Forms and does this staff understand the managed funds industry well enough to draw the proper conclusions from all this data.

V. Another important rule. While not required by Dodd-Frank, relates to customer protection.

The CFTC requires that FCMs **segregate customer margin** from the FCM's proprietary funds. We refer to these as **seg** funds. Maintaining customer funds in a separate account is supposed to **protect** these funds in case the FCM becomes insolvent.

In the past two years, two FCMs have become insolvent and assets belonging to customers have been returned slowly or not at all.

Peregrine is the easier of the two to describe. The owner of the FCM engaged in fraud, made up numbers to make it seem like his company was growing and successful. NFA uncovered the fraud and the FCM went into bankruptcy.

With MF Global, the company borrowed seg funds to meet its own margin calls on investments made for its own account. As questions arose about the stability of its investments, the margin calls from the firm's lenders got larger. In very simple terms, it couldn't meet these margin calls quickly enough, borrowed a significant amount from its customer seg funds and was discovered by the CFTC and NFA. Its downfall came about in just a few days.

In each case, the rules respecting segregation did **not protect the customer** as they should have.

Under its new customer protection rules, the CFTC along with the NFA has proposed and in some cases has already implemented a number of methods to protect seg funds. In the interest of time, I'll give only one:

The National Futures Association requires all FCMs to send to them electronically at the same time each day the amount of seg funds held by the FCMs. In addition, NFA requires all FCMs to direct their banks to send to the NFA electronically the amount of seg funds they hold for the FCM. The NFA compares the two numbers to ensure that all seg funds are properly accounted for.

Twice each month, NFA puts on its website the amount of seg funds held by each FCM. In this way, the public has access to these figures and can decide for itself whether it wants to use a particular FCM or transfer its money to a stronger FCM. There is some talk about making this information available more often.

VI. **Limitations on who may trade in the futures markets**

I've been asked to say a few words about which individuals may and may not trade in the futures markets under US law.

Only indirectly does the CFTC limit who may participate in its markets. For example,

The CFTC limits swaps trading to Eligible Contract Participants. Retail customers can only access this market if they are an investor in a fund that satisfies the definition of an ECP.

Also, if a fund or commodity pool limits its investors to all or almost all **qualified eligible persons**, it doesn't have to comply with all the reporting and recordkeeping requirements imposed on commodity pools. An individual may be a **QEP** if it has at least $2 million in securities investments or during the last 6 months has had futures margin or option premiums on deposit with an FCM of at least $200,000.

Most hedge funds require an investor to have net assets of at least $1.5 million, making them a qualified client inorder to satisfy certain SEC rules.

The CFTC recognizes that futures trading is extremely risky and that only risk capital should be used if one is to trade in the futures markets. NFA has rules requiring FCMs to use a "**suitability test**" to determine whether a customer should be allowed to open a futures account.

This test does not set forth a particular amount of money that an investor should own. Instead, it directs the FCM to look at all the facts and circumstances of

each case: the age of the investor, his annual income, his net assets, his debts, his experience in investing in derivatives and other similar factors.

Years ago when I was an attorney at the CFTC, the markets consisted primarily of hedgers, floor traders and individuals trading their own accounts or trading with the help of employees of their FCM. There were very few hedge funds or individual managed accounts traded by commodity trading advisors.

That's changed significantly with the passage of time. Now most investors in the markets are large traders, ECPs. A retail trader wanting to participate in the futures markets is most likely to invest in a hedge fund active in these markets.