ISDA Safe, Efficient Markets

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Introduction
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I had a flash of déjà vu as I prepared these remarks. It reminded me of the times I spoke as a CFTC commissioner at the forerunner of this event, SEFCon, on the forthcoming SEF rules. This conference proved to be an important forum for debate and discussion as the SEF rules were drawn up and finalized, and I know that, as a commissioner, I found that discussion incredibly useful.

Fast forward the nine or so years after I first spoke here, and we're talking about….you guessed it, forthcoming SEF rules.

Now, any Rip Van Winkles who have slept through the past decade might assume nothing has changed. Nothing could be further from the truth. In fact, there has been a huge transformation in derivatives markets between then and now. The vast majority of interest rate derivatives are now cleared, virtually all derivatives are reported to swap data repositories, margin rules are being phased in for non-cleared derivatives, and banks hold much higher capital.

And, of course, SEF trading has been up and running for five years. According to our latest analysis, roughly 56% of interest rate derivatives trading volume and 79% of credit derivatives volume was traded on a SEF in 2018.

Despite this very considerable progress, it's important that we continue to review the regulatory framework to ensure it is appropriate and doesn't result in unnecessary complexity and cost. Note that I say 'review' and not 'revoke'. The industry has worked very hard over the past 10 years to implement the regulatory reforms, and we believe the derivatives market is stronger and more resilient as a result.

We also believe, however, that we should not shy away from sensible changes when change is shown to be needed. For instance, when certain requirements have led to unnecessary complexity, duplication and costs.

That's why we at ISDA welcome CFTC chairman Giancarlo's commitment to review existing CFTC requirements, including the SEF rules and the cross-border guidance, and to propose alterations that make the framework simpler and more efficient.

I'll focus on both of those issues in my remarks this morning, and set out ISDA's view on the path forward.

It's interesting looking back that many of the issues we were debating during the immediate post-Dodd-Frank rule-making phase in 2011, 2012 and 2013 are the same as the issues that are being debated now.

For instance, when I voted on the final SEF rules back in May 2013, I highlighted my concerns with various aspects of the framework – notably, how derivatives should be traded on a SEF and the process for making a swap available to trade.

In particular, I argued that the required execution methods were more prescriptive and limiting than what was required by statute. Rather than allowing swaps to trade by "any means of interstate commerce" as set out in the Dodd-Frank Act, the SEF rules required just two methods of execution: a central limit order book and request-for-quote-to-three.

In some aspects, the CFTC was taking the model we had in place for futures. As we know, swaps and futures markets are quite different – both in terms of trade size and trade frequency. Nonetheless, the commission was trying to 'futurize' the swaps market. That did not come to fruition. Swaps remain large in size and some of them continue to trade bilaterally and by appointment.

To accommodate the legal mandate and the unique characteristics of swaps trading, and to tap into technology solutions, I felt we could craft a solution that provides transparency, allows innovation and recognizes the sophistication of market participants and the diversity of products traded. As a result, I argued that the rules should allow for more flexibility in the methods of execution, providing a wider array of options for derivatives users. I also emphasized the need to preserve some bilateral trading.

Spin forwards five or so years, and this issue is central to the current proposal put forward by the CFTC. A key feature of the new framework is to allow much more flexibility in execution.

Let's look at today's data. According to ISDA analysis, more than 3,300 fixed-for-floating interest rate swaps traded on average each day last year, with an average trade size of $83.7 million. About 58% of fixed-for-floating interest rate swaps notional was traded on SEF in 2018. That compares with 79% of forward rate agreement traded notional and 31% of OIS notional.

This data shows that the majority of swaps trade on SEFs, but a sizeable proportion do not. While the most liquid swaps may well be suited to CLOB or RFQ-to-three methodologies, other more bespoke trades may take longer to arrange and be better suited to other methods of execution. The most illiquid swaps, on the other hand, might need to be bilaterally negotiated and traded off-SEF in order to meet market participants' commercial needs. All these approaches are consistent with the statute.

This is actually an issue we've highlighted at ISDA. We've long argued that trading venues must offer flexible execution mechanisms that take into account the trading liquidity and unique characteristics of a particular category of swap.

There are, of course, details that need to be ironed out during the consultation. But we believe that permitting flexible methods of execution will encourage more trading on SEFs, and will help participants execute trades in more volatile periods, when liquidity falls in response to changing market conditions.

I look forward to hearing the views of chairman Giancarlo and commissioners Quintenz and Berkovitz on this issue, and to hear what feedback they've received during the consultation.

Turning back to 2013, another concern I had with the SEF rules related to the made available to trade process. This was actually something I voted against at the time, and the reason was very simple. I felt the CFTC and the market more generally had very little input in determining which products would be subject to a mandatory trading requirement.

While the CFTC in theory had to approve any determination, I argued the rule provided nothing more than illusory comfort that the commission had the ability to review or challenge a mandatory trading determination made by a SEF. In reality, the CFTC could do little more than rubber stamp a SEF's initial determination. This is a balancing act – especially for new or novel products. Think back one year and recall the intense debate the CFTC had over the trading of cryptocurrencies.

The CFTC's new proposal sets out a completely different method for determining which products have to trade on a SEF, based on whether they are both cleared and offered for trading by a SEF. This would result in many more products being brought into scope.

Nonetheless, the same questions are being raised about determining whether a contract has the necessary trading liquidity and whether market participants should have an opportunity to provide feedback before a contract is required to be traded on a SEF. We've pretty much come full circle.

That's not really surprising – this is a hard nut to crack and there are no easy answers. But we welcome and appreciate the CFTC's engagement on these points, and we hope to ultimately get to a good place. Again, I look forward to hearing the views of our keynote speakers and panellists on this issue.

Beyond the mechanics of SEF trading, the proposed rules give rise to another important question: what will these changes mean for cross-border trading?

Those of you who know ISDA will know that we care deeply about cross-border issues. We have long highlighted the need for greater consistency in rule sets across jurisdictions, and the importance of a transparent, predictable and timely process for making substituted compliance and equivalence determinations.

Up until recently, there has not been sufficient appreciation of the problems that occur when regulatory fragmentation grips a market. Without a robust process for cross-border recognition, counterparties would need to maintain multiple and, in many cases, duplicative compliance systems to meet the various rules simultaneously. This results in added cost, complexity and inefficiency.

Fortunately, there has been some progress on this front. At the end of 2017, the CFTC and the European Commission reached agreement on trading venue equivalence. In practice, the absence of holistic comparability determinations for non-US jurisdictions means challenges persist. For instance, a lack of comparability in reporting regimes means entities subject to both EU and CFTC regimes must report details of trades conducted on EU trading venues to both EU and US repositories, under different requirements and timings. Nonetheless, the 2017 agreement marks an important step in efforts to ensure a liquid global liquidity pool.

The question is, what impact will any change to the SEF rules have on this agreement? Personally, I believe we have to recognize that there are a range of trading facilities across jurisdictions, with different trading requirements and a different range of products. As this rule isn't focused on risk reduction, regulators should focus on outcomes when making comparability determinations, not a line-by-line analysis of the rules.

At ISDA, we have proposed a multi-pronged approach to tackling cross-border issues, and published a paper last month that sets out our latest recommendations on tackling fragmentation.

This includes employing a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes. Global standard-setting bodies should also develop a process that would address equivalence in a predictable, consistent and timely manner.

Under this framework, comparability evaluations would be based on whether a foreign regulatory regime has sufficient mechanisms in place to address or mitigate systemic risk. In contrast, non-risk-related rules like those on trading would be left within the remit of local regulators, and the focus for comparability should be on outcomes.

We think this approach strikes an appropriate balance by focusing on risk and its cross-border implications, rather than attempting to align each and every regulatory requirement between jurisdictions. It will also allow for outcomes-based substituted compliance determinations, while reducing the chances of lengthy negotiations that could lead to reduced liquidity and market fragmentation.

This was not the approach taken by the CFTC back in 2013, which essentially applied US rules to every other country. As a CFTC commissioner, I opposed this approach as being overly extraterritorial and unnecessarily complex and costly. Just imagine if every jurisdiction adopted this same approach of exporting its regulations. We would have an overlapping and unworkable regulatory structure.

Last October, CFTC chairman Giancarlo recognized the difficulty this has caused, and published a whitepaper dubbed Cross-border Swaps Regulatory Version 2.0.

The paper proposes to focus on cross-border systemic risk when making comparability determinations, and to allow greater flexibility and jurisdictional tailoring for non-risk-based reforms meant to address market structure and trading practices.

Again, there are details that need to be ironed out, but we are encouraged that the whitepaper sets the stage for recognizing a risk-based approach to regulation of cross-border trading.

I'd like to commend chairman Giancarlo for engaging on this issue and proposing an alternative to the currently over-expansive cross-border guidance.

When I spoke at some of those early SEFCon events as a CFTC commissioner, little did I think I'd be standing here again nearly a decade later talking about the SEF rules and the CFTC's cross-border guidance.

I'm not discouraged by that, and neither should you be. We've come a long way very fast. The derivatives markets have changed beyond recognition. They are much safer and much more resilient that they were back then.

It's absolutely right that we take the opportunity to review the rules that we have in place and ask how they can be made to work better. The CFTC now has the benefit of experience and data. That's something my colleagues and I at the CFTC didn't have when implementing Dodd-Frank.

We welcome the CFTC's commitment to improving its rules, and I'd like to thank chairman Giancarlo and the CFTC commissioners and staff for reaching out to the industry and taking the time to listen to feedback.

I'd also like to take the opportunity to thank chairman Giancarlo and commissioners Quintenz and Berkovitz for giving keynote remarks today.

Finally, I'd like to thank all our panellists, our sponsors, and our friends at the TABBGroup for co-hosting this event. I'm looking forward to hearing more about the potential impact of the reforms and how we can ensure we have global, liquid and safe markets going forward.

I hope you enjoy the conference.