7-2015

My Thoughts and Reflections on the Fifth Anniversary of the Dodd-Frank Act and Other Current Matters

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Recommended Citation
35(6) FUTURES AND DERIVATIVES LAW REPORT 6-9 (July 2015)

REPORT

The Journal on the Law of Investment & Risk Management Products

Futures & Derivatives Law

Special Edition: 5th Anniversary of Title VII of the Dodd-Frank Act

July 2015 ▪ Volume 35 ▪ Issue 6

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INTERNATIONAL COOPERATION WILL BE CRITICAL IN ACHIEVING EFFECTIVE REGULATION OF SWAPS

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During the height of the financial crisis, world leaders meeting in Pittsburgh recognized that constructing a new regulatory system to govern the swaps market would present unique challenges requiring a coordinated, global response. At the 2009 Pittsburgh Summit, these leaders agreed to work together to strengthen the scope of regulation of over-the-counter derivatives in order to prevent similar crises in the future. The Leaders' Statement released after the summit announced a commitment "to take action at the national and

Futures and Derivatives Law Report is pleased to publish this special edition containing the reflections of the members of our Editorial Board on the 5th anniversary of the enactment of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Members of our Editorial Board are among the most experienced and respected lawyers in the derivatives bar. They have spent the past 5 years studying and advising their clients and others on the nuances of Title VII and the regulators' swaps proposals, rules, interpretations and letters. We know you will find their thoughts interesting and provocative.

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." The leaders vowed that "[a]ll 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," that "OTC derivative contracts should be reported to trade repositories," and that "[n]on-centrally cleared contracts should be subject to higher capital requirements."

Although the Commodity Futures Trading Commission (CFTC) and the European Securities and Markets Authority (ESMA) have made significant strides individually in drafting and implementing regulations, an inconsistent approach among jurisdictions risks undermining their efforts to some degree. Moreover, without a renewed commitment to international coordination and harmonization, it is possible that the vision of the Pittsburgh Summit of raising standards together and avoiding fragmentation of markets, protectionism, and regulatory arbitrage could be compromised. In addition to adversely effecting market liquidity, it is possible that differences in regulation among jurisdictions might introduce operational risks to the global markets. The swaps market, which has long encompassed transactions between counterparties across national borders, necessarily requires the consistent and coordinated approach that the G-20 leaders envisioned in Pittsburgh.

Need for Substituted Compliance

The CFTC took an early and leading role in implementing the reforms envisioned by the G-20 leaders as codified in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). As a consequence of its efforts, the CFTC has set the global standard for mandatory clearing of swaps and trading such swaps on multilateral trading facilities. By taking the lead in implementing its rules, the Commission not only defined a global standard, but at the same time, put substantial pressure on international regulators to adopt consistent standards. As the first to adopt rules, the CFTC is now faced with the issue of how to respond if other jurisdictions adopt differing standards.

The CFTC has been a thought leader internationally on issues of international comity and substituted compliance with respect to futures regulation. The CFTC for over 25 years has permitted U.S. persons to access directly foreign boards of trade, first under a line of no-action letters and more recently under the registration framework in Part 48 of its rules. Moreover, the Commission exempts certain foreign intermediaries based on their compliance with a comparable regulatory framework in their home jurisdictions.

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uncleared trades, the additional cost may be difficult to quantify as it will likely be reflected in greater spreads rather than in identifiable fees. In addition to capital requirements, compliance with the new Volcker Rule is expected to result in significant new constraints on bank market-making activities. This too may result in fewer transactions and wider spreads for end-users. Similarly, there is concern that execution requirements on swap execution facilities will prematurely expose trades to the market and, as a consequence, also engender wider spreads.

To assess the impact of the new costs associated with D-F one must consider the impact of all the new measures in the aggregate. That is indeed difficult, if not impossible, the more so because one response to these heightened costs may well be a material curtailment in the number of hedging and other types of derivatives transactions entered into by end-users. The financial risk associated with curtailed hedging will then be passed along to consumers in the form of higher prices (whether for air travel or imported machinery). It will not show up as a line item on the financials of business entities, but it will impact the performance of the overall economy.

Finally, another indirect cost is the curtailment of negotiated early termination rights that result from the new Orderly Liquidation Authority in Title II of D-F and the "living wills" required under Title I. A better appreciation of the potential significance of these new statutory and regulatory changes is taking place now as a result of the ISDA 2014 Resolution Stay Protocol. The debate surrounding this Protocol highlights the larger question of whether end-users will benefit from the D-F reforms during the next financial crisis. Certainly, many of those reforms, such as the new clearing, margin and capital requirements (whose implementation accounts for many of the aforementioned costs being imposed on end-users) are designed to reduce the risk of failure by our largest financial institutions. However, it appears that financial risk has become even more concentrated since passage of D-F in a small number of CCPs and banks. Whether the additional costs being borne by end-users are justified will likely depend on whether the efforts to avoid financial calamity through new resolution regimes prove workable. Hopefully, we will wait a long time before these new resolution regimes are put to the test.

MY THOUGHTS AND REFLECTIONS ON THE FIFTH ANNIVERSARY OF THE DODD-FRANK ACT AND OTHER CURRENT MATTERS

By Professor Ronald Filler
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It seems like just yesterday that we were all conjecturing what the impact of the Dodd-Frank Act ("DFA") on the derivatives industry might be. Yet, now, some five years later, that uncertainty still exists. We really do not know at this time, its true impact and whether Messrs. Dodd and Frank did the right thing then or not.

I am a big believer in how clearing can and does reduce systemic risks. Therefore, I supported then, and still do today, the mandatory clearing requirement imposed on OTC derivatives under Title VII. Obviously, such a belief depends on clearinghouses setting the proper initial performance risk levels and in providing the requisite financial resources to ensure their financial integrity. To date, I believe that the four big clearinghouses (CME, ICE, LCH and EUREX) have done an admirable job in meeting these unique challenges but, to be honest, we will really not know the true answer until there has been an actual default by one or more of their largest clearing member firms. And that really is the key theme, that is, will the CCP's financial resources be sufficient to ensure the financial integrity of the CCP following such a default and will OTC clearing participants be protected. A failure by any CCP, especially one of the Big Four, would be devastating on the system and have an ever-lasting effect. Participants will definitely lose faith in the system that was designed to prevent such an occurrence.

As I said before, I am a believer. Having served on several CCP Boards and CCP Risk Advisory Committees during my 35+ years in this great industry, I really do believe that the CCPs will always do the right thing, I also do hope that I will never be proven to be wrong on this belief.

At the same time, I am a critic in the way the CFTC has administered its duties and obligations following the passage of Dodd-Frank. While I strongly applaud and admire its success in adopting the 60+ regulations required by the DFA, I do not agree at all with the process the CFTC applied. New and highly complex regulations were hastily enacted, many with as little as 60 days' notice of their effective date. Such haste has resulted in the issuance of hundreds of no-action letters, some just hours before the effective date, on so many of them.

In my long career in the futures and derivatives industry, with many of the years spent at large FCMs, the one thing that I have learned is that operations and technology drive this business. No firm or person can properly ever state that they are in a position to comply with a regulation until the back office system has been written and tested thoroughly. And no back office system will be effective until the IT department is able to produce the required records, and provide the proper reports, so that senior management has the necessary tools to review the trading or other activity that is taking place to ensure that the firm is in compliance.

Don't get me wrong, I have known and have highly respected the CFTC and its staff since 1975. I have known every Chair and Commissioner, every Division Director and most of the senior CFTC staff since April 1975 when its doors first opened. They were and are highly qualified professionals and have always been willing to listen to others' views. However, their push to get the new DFA regulations in effect so quickly clearly backfired and forced the CFTC staff to issue these numerous no-action letters. All they had to do was simply adopt the regulations and then make their effective dates with realistic timetables of 6-9 months later, not 60 days later. The no-action letters ultimately achieved these later effective dates but at the result of needless scrambling and tremendous expenses incurred by the industry as well as a loss of credibility for the CFTC. Our federal regulatory agency needs to set the global standard. They normally do but not so with requiring 60 days' effective dates on so many of these new DFA regulations.

Finally, the Cross Border Guidance needs to be withdrawn and re-issued as a new regulation. The DC District Court got it wrong. You cannot adopt a Guidance and expect the industry to assume that it will not apply to them in an enforcement action. The ultimate threat is real. The harm done by the Guidance is real as well. Whatever happened to the global harmonized approach that all G-20 countries agreed to in September 2009 in Pittsburgh? Granted, everyone else outside the US took a slower, some would argue a more considered, path and therefore missed the December 2012 deadline agreed to in Pittsburgh. And, yes, some countries still have not taken any action. So what? OTC derivatives are a global business. All of the top 15 firms in this business have offices and affiliates around the globe. Many are major non-US banks with affiliates in the US. The DFA anticipated a better risk management approach to ensure, to the extent possible, that we would never have another major bank failure, and, more importantly, never ever require another bailout. The legislation specifically recognized the need for a greater harmonized regulatory approach relating to OTC derivatives and gave the regulators great latitude in designing the operating framework. The worse thing to occur, and it has occurred, is the infighting between Europe and the US and the contest about whose regime will be triumphant. Harmonization is not about winning. It's called sharing. It's also called comparability within proper parameters. Hopefully, the new leadership at the CFTC and the European Commission will agree to share and accept comparability between the US and EU.

Query, why couldn't the CFTC have simply applied a Part 30 model to OTC derivatives? This model of comparability has been effectively used by the CFTC for years relating to futures. Under Part 30, U.S. retail futures customers (you know, you and me) can trade in the Hong Kong and Singapore markets or on most other non-US futures exchanges through a local broker without requiring that foreign broker to register as an FCM. The CFTC has honored the comparable futures regulatory systems in many non-U.S. countries for over 25 years. The foreign broker need only be a member of the non-U.S. futures exchange and file a Consent to Jurisdiction form with the NFA. Oddly, sophisticated U.S. institutional OTC customers cannot trade swaps with a non-U.S. counterparty unless that counterparty is registered as a swap dealer with the CFTC, assuming the *de minimis* rule does not apply. The CFTC could simply have expanded Part 30, with all of its regulations and practices in place, to OTC derivatives. It chose a more difficult and contentious path.

I have also not understood the CFTC's philosophy in requiring different regulations for the OTC market versus the futures market. A good example is the LSOC rule. There, OTC customers receive preferential treatment if their FCM goes bankrupt whereas futures customers at that same FCM must bear the burden of having their assets used to pay the trading losses incurred by another customer of that FCM. Pro rata is pro rata under the U.S. Bankruptcy Code, not unique and different.

Finally, can someone please explain to me how $7.999 billion of trading of OTC derivatives is *de minimis* and does not require that swap dealer to register with the CFTC whereas $8.0 billion qualifies as having a "direct and significant effect on the U.S. economy" as required by Section 721. It's a direct and significant test, not either one. I grew up in a small country town in NW Tennessee (where the drinking age and driving age is 5'2") so I guess my math background is not as sophisticated as those who live in Washington but I always thought that the U.S. economy is quite large. This must have simply been a typographical error as the CFTC probably meant to add 3-4 zeros to the end of that $8.0 billion number.

I have now spent 35+ years in this great industry. I have been truly honored to know some very great and wonderful people. I have taught a law school course on the CEA, CFTC and industry regulations, and industry customs and practices since 1977, first at the Chicago Kent College of Law, then later at Brooklyn Law School, the University of Illinois College of Law and now at New York Law School. It was called Commodities Law in 1977 but has been renamed as Derivatives Law just to show others that I can adjust. I just co-authored a treatise on Derivatives Law with my good friend, Prof. Jerry Markham. In fact, that was a dream that I had for over 35 years. In 1978, another good friend and colleague, Michael Weiner, the former GC of the CME, and I signed a book agreement with Little Brown & Co. to write a law treatise on Commodities Law. Michael and I spent numerous hours and weekends in the Law Library at Northwestern Law School, which housed the entire publication of CEA Administrative Proceedings (that's the Commodity Exchange Authority for you younger people), but we just did not have the time, or maybe it was the energy, to complete the book. Phil Johnson did it instead. And now, I have fulfilled that dream through my new book with Prof. Markham. Finally, I do not know an actual number but I'm guessing that over a hundred of my former law students now work in this great industry. I call them "Filler's Army" and that army is still growing each and every year. You see, I have been truly blessed. That's the real truth.

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