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Committee on Agriculture

Subcommittee on Commodity Exchanges, Energy and Credit

To review the impact of the G-20 clearing and trade execution requirements

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Introduction

Chairman Scott, Ranking Member Scott and Members of the Subcommittee, thank you for holding this hearing and for extending JPMorgan Chase the opportunity to present our views. My name is Marnie Rosenberg, and I am the Global Head of Clearinghouse Risk and Strategy within JPMorgan Chase's independent Risk Management Function.

We appreciate the Committee's leadership in holding this series of hearings to review implementation of the derivatives reforms agreed by the Group of Twenty (G20) in 2009[1]. It is and will continue to be important to ensure the objectives of increased transparency and a reduction in systemic risk are being met, while also monitoring the impact on the derivatives markets and the ability for businesses to access those markets to manage risk.

As this Committee knows well, American companies use futures and swaps to manage a wide variety of risks they encounter in their day-to-day business, such as interest rate risk when companies borrow money, currency risk when they sell their goods overseas or commodity risk posed by fluctuations in prices of raw materials used in production.

JPMorgan works with companies from all industry sectors who seek to hedge their risks in the swaps markets, which allows them to do so in a flexible and customized manner that is not possible in the exchange-traded markets. We serve end users by providing liquidity, financing and customized risk management solutions across markets, including energy, metals and agricultural markets.

In addition, JPMorgan is a leading provider of access to clearing across the globe, with fifty-four memberships at forty-two clearing houses, or "CCPs" that offer futures and/or swaps clearing. In addition to its clearing memberships, JPMorgan provides services directly to CCPs globally, acting as a liquidity provider, cash manager, investment advisor, settlement bank and custodian.

I lead a team that focuses on understanding current and proposed CCP structures and identifying, mitigating and reducing membership risk and exposures to enhance how JPMorgan measures and manages our exposure to CCPs. We apply this experience and expertise to develop policy

[1] http://www.g20.utoronto.ca/2009/2009communique0925.html

recommendations on CCP risk issues and to pro-actively engage in policy discussions affecting CCPs to best ensure a safe and sound financial system.

Today, I will focus on the importance of robust risk management frameworks at CCPs to the safety and soundness of the financial system.

Overview of State of Reform

Following the financial crisis, the leaders of the G20 nations agreed to a series of measures to increase the transparency of the over-the-counter (OTC) derivatives market and to reduce systemic risk. The reforms agreed to by the G20 included clearing of standardized OTC derivatives through CCPs, trading of standardized OTC derivatives on electronic platforms where appropriate, higher capital and minimum margin requirements on non-centrally cleared contracts, and requiring that all OTC derivatives transactions be reported to trade repositories.

Global initiatives have been underway to implement these changes for some time and they are in various states of legislation, regulation, and implementation. Many of these reforms have brought significant progress in a number of key areas, including: mandatory registration and regulation of swap dealers; mandatory clearing of standardized contracts between financial firms; greater pre- and post-trade transparency through public reporting requirements; and execution of certain standardized contracts on swap execution facilities (SEFs).

The Commodity Futures Trading Commission (CFTC) has written and adopted the bulk of regulations required to implement swaps market reforms under Title VII of the Dodd-Frank Act. These and other reforms, taken together, have reduced risk in the system and have facilitated greater transparency for regulators and market participants. They have also fundamentally altered the market structure of swaps: how and where these instruments are traded, the economics of transactions, the nature of products available to American companies and the liquidity and efficiency of these markets. And as I will discuss later in my testimony, mandatory clearing, in particular, has intensified the importance among regulators and market participants for CCP risk management standards across all clearinghouses, not just those that clear derivatives. This development is a positive outcome for overall market stability but our work is not yet complete. CCPs have now become deeply interconnected and core to our derivatives markets but we have yet to fully evolve their risk management and governance models to reflect this increasingly critical role.

This change in market structure is demonstrated by the fact that, for the interest rate swap markets as of the first quarter of 2016, 82.5% of the average daily notional value is now centrally cleared, and nearly half of the average daily trading activity is executed on a swap execution facility[2]. In contrast, in 2013, only 57.7% of the average daily notional value of interest rate swaps market was centrally cleared.

Now that the rules are largely in place and cleared volumes have increased, it is important for the CFTC and other policymakers to: 1) consider the implications of the changes to the derivatives markets, such

[2] http://www2.isda.org/functional-areas/research/research-notes/

as the growing importance of central counterparties to financial stability, and fragmentation in swaps markets; 2) review how emerging risks might best be managed and mitigated; and 3) determine whether adjustments to the rules or additional guidance may be appropriate to ensure the markets continue to meet the needs of all market participants.

The following observations and recommendations should be considered as the Committee and the CFTC continue their ongoing work in this area:

- Mandatory clearing requirements can reduce risk in the derivatives markets. As the volume of centrally-cleared contracts has increased, however, so has the importance of CCPs as sources of systemic risk. Expectations are that CCPs will only continue to grow in size, importance and inter-connectedness.

- Inter-connectedness among systemically-important CCPs and clearing members has increased across jurisdictions. Global CCPs share a common set of large members, raising the likelihood that a default at one CCP will have a cascading effect across the globe. These connections must be mapped and well-understood, and broader industry preparedness is needed to ensure that member default can be contained.

- It is critical for policymakers, regulators and market participants to review the existing CCP risk management, governance and oversight models to ensure they are commensurate with the systemic risk they now pose. Stakeholders need to ensure that sufficient safeguards are in place to promote the resilience of CCPs, and that there are robust plans in place to manage extreme stresses to the financial strength of a CCP without the use of public money. Similarly, operational resiliency is of paramount importance, requiring strong operational risk and cybersecurity risk management. Specifically:

    - ***CCPs should be subject to enhanced resiliency standards.***
        - Effective risk governance is the fundamental building block for resilient CCPs. CCPs should be subject to global minimum governance standards and "skin in the game" requirements to promote effective alignment of interests and proper risk management.
        - CCPs should be transparent to market participants regarding their risk methodologies used to size their aggregate financial safeguards. Higher minimum standards are needed for CCP stress testing frameworks, and standard regulatory-driven, disclosed stress test frameworks should be implemented to provide confidence in the adequacy of loss absorbing resources held by CCPs.
        - Regulators, CCPs and clearing members globally should work together to implement and test default management protocols in a coordinated manner across CCPs.

    - ***Robust recovery tools should avoid pro-cyclicality and market destabilization.***

    - A CCP's ability to make cash calls on its members as part of recovery must be very limited and subject to a consistent global standard.
    - Use of novel recovery tools, such as contract tear-up or gains haircutting, have the potential to impose unpredictable losses on participants and should be limited in CCP recovery and overseen by an impartial authority.

  - ***Resolution plans should ensure continuity of clearing services while minimizing risks to financial stability and to taxpayers.***

- At the same time, new capital requirements under the leverage ratio do not adequately reflect exposure from cleared derivatives and have made it difficult for many clearing member banks to offer clearing services. End users are beginning to feel the impact of this constraint through reduced access to clearing and increased costs.[3] This creates a distinct tension between the safety and soundness objectives of prudential regulators and those of market regulators, like the CFTC, responsible for implementing the G20's clearing mandate to reduce risk in the derivatives markets.

- The recent agreement between the CFTC and the European Commission with regard to recognition of US-based CCPs by European authorities was a critical development in ensuring a global market for swaps. It also underscores the importance of cross-border coordination on an ongoing basis among regulators around the world, particularly as US and EU authorities begin discussions related to trading venue equivalence.

- Finally, the use of SEFs is an important mechanism for enhancing transparency in the swaps markets. Minor adjustments to the CFTC's rules setting out the process for determining swaps mandated to be traded on a SEF and the modes of execution permitted would help to mitigate unnecessary reductions in liquidity that have been widely observed since the SEF rules went into effect.

The New Clearing Ecosystem

I. CCP Resiliency, Recovery and Resolution

One of the key components of the G20 agenda on derivatives reforms was mandating the use of CCPs for the clearing of all standardized OTC derivatives contracts. A CCP interposes itself between counterparties to a derivatives transaction, whereby the CCP becomes the buyer to every seller and the seller to every buyer. The use of CCPs creates numerous benefits for market participants and the financial system by providing for centralized risk management and processing as well as risk reduction through collateralization of trades and multilateral netting.

[3] http://www.sifma.org/issues/item.aspx?id=8589958563; http://www.commoditymkts.org/wp-content/uploads/2015/11/CMC-MFA-Leverage-Ratio-Letter-End-User-Impact-Final.pdf

The increased use of CCPs has led to concentration of credit, liquidity, operational and legal risk arising from OTC derivatives in a small number of the large global CCPs. These risks are now centrally managed by CCPs themselves and market participants must rely upon CCPs to maintain appropriate membership criteria and risk management standards, and conduct ongoing, adequate member due diligence. This dependency upon CCPs to maintain strong risk management standards existed prior to the introduction of mandatory swaps clearing but has now become more pressing as mandatory clearing in multiple jurisdictions has led to further concentration of risk while, at the same time, market participants no longer have the option to execute and clear bilaterally if they become concerned with a CCP's risk management protocols. While mandatory clearing has been in effect in the US for nearly three years, market participants will need to begin complying with the European Union's (EU) clearing requirement for OTC derivatives products later this month[4]. Other jurisdictions have also moved forward with mandating the use of CCPs for certain standardized OTC derivatives. Further, as rules imposing margin requirements on swaps that are not cleared are implemented beginning in September 2016, an even greater use of CCPs is anticipated from market participants seeking to voluntarily clear additional products to benefit from margin efficiencies and multilateral netting that can be gained through clearing.

Due to JPMorgan's role as a significant clearer in global derivatives markets, it is imperative that we understand our own exposure and risks to CCPs, and evaluate how and whether the current regulatory and legal structures for CCPs are sufficiently suited to their growing importance to the financial system. This is why JPMorgan published a paper in 2014 called "*What is the Resolution Plan*" for CCPs[5].

In the current derivatives clearing "ecosystem", policymakers and market participants need to address some key questions:

- Are CCPs sufficiently resilient that they can withstand a clearing member(s) default or major loss through sufficiently strong first line of defense measures: are membership criteria robust, is eligible collateral limited to the highest quality liquid assets and are products that are cleared sufficiently liquid, standard, and suitable for clearing?

- Do CCPs have adequate plans to recover from such a loss and carry on offering critical services?

- If CCPs can't recover, do they have adequate plans to continue to provide critical services and ensure the failure of a CCP does not cause wider market instability or require taxpayer assistance?

In response, we have come a long way, but more work is needed.

Currently, CCPs are expected to meet higher regulatory and risk management standards, including internationally agreed to standards published by the Committee on Payments and Market Infrastructure

[4] https://www.esma.europa.eu/regulation/post-trading/otc-derivatives-and-clearing-obligation
[5] https://www.jpmorganchase.com/corporate/About-JPMC/document/resolution-plan-ccps.pdf

(CPMI) and the International Organization of Securities Commissions (CPMI-IOSCO) in 2012, referred to as the Principles for Financial Market Infrastructures (PFMIs)[6] as implemented in the US by CFTC rulemakings under authorities in Title VII and Title VIII of the Dodd-Frank Act. Nevertheless, regulators around the world have acknowledged that more work is needed, and CCPs have become a high priority on the agenda for global financial regulatory standard-setting bodies, including the Financial Stability Board and CPMI-IOSCO and we expect this focus to continue. These bodies are largely comprised of regulators, central bankers and in some cases, finance ministries from the US and around the world.

CCPs Should be Subject to Enhanced Resiliency Standards

A resilient CCP should have the ability to withstand severe stress events such as clearing member defaults, and this can be achieved by having strong membership requirements to ensure the soundness of its clearing members while also ensuring fair and open access, robust risk management standards and adequate capital and liquidity resources. A resilient CCP must also be able to have sufficient controls and protections in place to withstand significant losses stemming from non-default events, such as fraud or a cybersecurity attack.

There are four key recommendations on how to improve CCP resiliency and strengthen the clearing ecosystem:

1) Effective risk governance is the cornerstone of resilient CCPs. CCPs should be subject to global minimum risk governance standards and "skin in the game" requirements to promote effective alignment of interests and to incentivize strong risk management.

Many CCPs have migrated from being utilities owned by members to private for-profit institutions. This shift introduces an inherent tension and potential conflict of interest between a CCP's role as a market utility that can mutualize potential losses among its members and its commercial objectives to increase revenues and earnings/dividends for its shareholders and market share. The fact that its members bear the losses also introduces an element of moral hazard.

CCPs make key decisions impacting the risk profile of the CCP and its membership, with respect to the products that can be cleared, the members who participate in the CCP, the framework used to mitigate the risk brought in by participants, the type of collateral that can be posted and the aggregate amount of safeguards to maintain. However, it is clearing members of the CCPs that bear the capital consequences of any losses, through the collective funds (the "default fund") they provide to the CCP for loss mutualization. Therefore, CCP risk governance structures should evolve to ensure that those that bear potential losses and market risk as part of default management have a meaningful voice with regard to how risk is brought into the CCPs. Governance needs to be commensurate with the changed role of CCPs and the new responsibilities that CCPs have within the financial system. This can be achieved by mandatory, meaningful consultation and inclusion in the decision making process for clearing members, availability of appropriate, funded amounts of a CCP's own resources ("skin in the game") and increased capital available at the end of the waterfall.

[6] http://www.bis.org/cpmi/publ/d101a.pdf

Governance. Members themselves must have more of a say in material risk decisions that are made by the CCP as it impacts their own capital contributions through the default fund. Current US regulation does not require CCPs to incorporate and demonstrate input from clearing members or CCP risk committees early in the process with respect to key risk management decisions impacting clearing members' liability. CCPs globally should therefore be required to obtain input from their clearing members and the CCP's relevant risk committees on all material risk matters such as products that can be cleared, changes to loss mutualization rules, and post-default risk management decisions. CCPs should be required to maintain records and report any conflicts between CCP decision, risk committee opinion and clearing member views. In addition, consistent global standards are needed with respect to a CCP's risk committees. Risk committees should be required to have clearly-defined mandates, diverse memberships, and minimum member qualifications. The risk committee representatives should provide an independent, expert opinion on a CCP's risk management strategy and the impact of a CCP's actions on CCP and member stability, market integrity and clients[7]. If the views of a CCP's risk committee are not incorporated by the CCP in making key risk management decisions, the CCP should be required to document and disclose to regulators how the risk committee's views have been addressed.

"Skin-in-the-game". CCPs should be subject to a meaningful risk-based minimum contribution to the guarantee fund ahead of non-defaulting members called "skin in the game" (SITG). While many CCPs currently contribute such capital to their overall financial safeguards, the current level of CCP contributions, at generally less than 5% of the member default fund, are not sufficient. The CFTC currently does not require CCPs to have minimum SITG capital contributions. CPMI-IOSCO is expected to issue a market consultation this year to set global standards, which is a welcome and positive development. Having a risk-based, minimum level of SITG would appropriately align incentives amongst the CCP and its members and ensure proper risk management and governance. Aligning and scaling CCP contributions with those of the largest clearing members will also help to ensure that membership requirements remain strong and will limit the possibility that any single member becomes too large as a proportion of total risk.

CCP Capital. The current minimum CFTC and global capital requirements for CCPs should be reviewed. Currently, CCPs are required to cover at least six months of operating expenses under CPMI-IOSCO standards and twelve months under CFTC requirements. This is primarily meant to cover business and operating risk and any losses that arise by a non-member default event such as cyber risk, technology failure, or fraud. However, CCP capital should be available for *both* default and non-default losses. Members should not be responsible for non-default losses. This should be the responsibility of the CCP's shareholders. The size and impact of such events are untested and the current capital levels may be insufficient to cover losses. Sufficient standards are needed to address operational risk, and in particular, cyber-risk through investments in expertise and ensuring infrastructures to handle these risks are adequate. This is front and center on the international regulatory agenda and the work done by CPMI-IOSCO and the CFTC to address these risks through consultations on cyber security and operational controls is another welcome and positive development.

[7] https://www.theclearinghouse.org/issues/articles/2015/09/20150918-tch-comments-to-cpmi-iosco-on-ccp-risk-governance

2) CCPs should be more transparent to market participants regarding risk methodologies used to size their aggregate financial resources to cover the largest single (or two) member defaults[8].

Clearing members and their clients must have access to and transparency around the methodologies used by CCPs to develop financial safeguards in order to identify and manage the risks inherent in using a specific CCP. For example, transparency regarding stress scenarios used by a CCP to determine the size of financial safeguards is necessary to provide clarity to participants on whether the CCP has sufficient resources to absorb default losses.

While the industry has made significant progress on CCP transparency over the last three years, more must be done. Regulators around the world continue to voice support for market participants' calls for transparency and now require public disclosures through the CPMI-IOSCO quantitative disclosures standard that was published in February 2015[9]. Current, standard disclosures are useful to participants on many levels but these disclosures alone are not sufficient as they do not permit CCP users to replicate margin models and do not provide details of the stress scenarios that a CCP has determined it will be able to withstand. The more market participants can adequately measure and manage their credit risks to CCPs, the more confidence the system will have that CCPs have sufficient resources to withstand a crisis.

3) More prescriptive, minimum global standards are needed to govern CCP stress testing along with the establishment of standard regulatory-driven, disclosed stress test frameworks to provide confidence in the adequacy of aggregate financial safeguards held by CCPs.

Adequate stress testing of CCP members and their client portfolios is key to evaluating whether a CCP has sufficient resources should a clearing member(s) default. To ensure this, a CCP's financial safeguards should be sized based on CCP-designed stress test frameworks that are subject to minimum and more prescriptive standards that are transparent to clearing members and other market participants. In addition, there should be regulatory-driven stress tests that then provide oversight and inform supervisory requirements by evaluating the adequacy of the CCP's financial safeguards with appropriate consequences should a CCP fail the test.

There has been significant progress towards enhanced standards for stress testing[10], and CPMI-IOSCO is expected to issue a consultation with additional guidance for CCPs in the third quarter of 2016. In addition, European regulators recently conducted stress tests of CCPs in Europe, and it is important that such a framework is extended to CCPs globally.

4) Regulators, CCPs and clearing members globally should work together to develop, implement and test standard default management protocols in a coordinated manner across CCPs.

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[8] http://www.bis.org/cpmi/publ/d101a.pdf

[9] http://www.bis.org/cpmi/publ/d125.pdf

[10] In July of 2015, ISDA sent a letter to CPMI-IOSCO setting out the industry's principles for CCP stress testing: www.isda.org

It is important for policymakers to consider that a large clearing member default could occur simultaneously at multiple CCPs and that CCPs are highly dependent upon non-defaulting members to help manage the default, participate in the default management process and absorb the defaulter's portfolio with its associated market risks. A CCP's dependency upon the resources and expertise of its broader membership to achieve a successful default management outcome cannot be underestimated, and market and prudential regulators, CCPs and all of their participants have a vested interest in making sure this happens. Currently, while each CCP tests its default management protocols with its members through default management fire drills, these drills are done in isolation and not in collaboration with other CCPs. An extreme market stress event that occurs across CCPs in multiple jurisdictions could severely constrain the ability of non defaulting members to respond effectively. In order to ensure market preparedness for such an event, a coordinated approach to drills under the joint oversight of relevant regulators, and a push for more standardized default management protocols among global CCPs is necessary. As an example, a recent joint default management exercise run by UK and German authorities coordinated across two CCPs, LCH and Eurex, was an important step in the right direction. However, more is needed, including involvement of US CCPs and authorities in future work. This will be a topic at an upcoming Market Risk Advisory Committee meeting at the CFTC, for example, which is a very welcome development.

Robust Recovery Tools Should Avoid Pro-cyclicality and Market Destabilization

Focusing on CCP resilience is a necessary first step, but it is not sufficient on its own. To the extent that resiliency measures are not sufficient, CCPs are required to have robust recovery plans that ensure continuity. "Recovery" refers to the ability of a CCP to recover from a threat to its viability so that it can continue providing its critical services without entering into resolution or insolvency. While efforts are appropriately focused on reducing the likelihood of any CCP entering recovery, it is important that CCPs are prepared through comprehensive and effective recovery plans that are also transparent, measurable and acceptable to members who bear the majority of the risk.

In 2013, the CFTC adopted rules requiring systemically important CCPs to comply with international standards for CCPs, including a requirement to maintain viable recovery plans. Since that time, US CCPs have been revising their end of waterfall rules to put in place robust processes, agreements and defined tools to support recovery.

Clearly defined, transparent, and robust *ex ante* CCP recovery plans that do not lead to destabilizing and pro-cyclical effects are essential. Specifically:

1) A CCP's ability to make cash calls on its members as part of recovery must be very limited and be subject to a consistent global standard.

Currently, CPMI-IOSCO and the CFTC do not prescribe rules with respect to the number of cash calls that a CCP can impose upon its members. This has led to CCPs implementing varied rules which make it difficult for members to measure and manage their own exposures. The interconnectedness among CCPs suggests that there could be multiple, simultaneous cash calls on the same clearing members. In

the absence of limits, the cash calls may not be reliable, particularly in a stressed market, and could lead to liquidity and funding issues that would be vectors for further financial instability.

2) Use of novel recovery tools, such as contract tear-up or gains haircutting, have the potential to impose unpredictable losses on participants and should be limited in CCP recovery and overseen by an impartial authority.

Gains haircutting is a tool for allocating losses in recovery that is being implemented by CCPs to satisfy their regulatory requirement to ensure comprehensive loss allocation. This tool allows CCPs to reduce any payments it owes to participants. Most importantly, it could lead to disproportionate distribution of losses to certain market participants, which could in turn incentivize such participants to take actions with respect to their positions that are destabilizing or otherwise inhibit the CCP's recovery.

Similarly, CCPs have proposed partial tear-up as a way to restore the CCP to a matched book should default management protocols fail to successfully liquidate the defaulter's portfolio. The CCP would tear-up positions of the defaulter and those non-defaulting participants that hold equal and offsetting positions at a price determined by the CCP. Because this tool would be used during a period of illiquidity, establishing a fair market price would be quite challenging and subjective on the part of the CCP.

A CCP's decision to use recovery tools like gains haircutting and partial tear-up should be overseen by an impartial authority, and require compensation to be paid by the CCP to participants who suffer losses. While the CPMI-IOSCO recovery report already contemplates compensation in particular, US regulators should consider issuing guidance in this regard.

Resolution plans should ensure continuity of clearing services while minimizing risks to financial stability and to taxpayers.

If a CCP is no longer a viable entity for the performance of its critical functions, it should be resolved in a manner that is not disruptive to the marketplace, is not reliant on taxpayer assistance and allows for operational continuity of a newly capitalized entity under new ownership that can continue its critical functions.

The trigger point for resolution should be the point at which the exercise of recovery tools becomes too destabilizing for the market, threatens the sustainability of the CCP or when the CCP is otherwise near or in default. As opposed to recovery, a resolution would be managed by resolution authorities, such as the Federal Deposit Insurance Corporation (FDIC) in the US, and could lead to a change in ownership, a write-down of the CCP's equity and the replacement of the CCP's management.

Resolution authorities should develop public sector playbooks or action plans that facilitate continuity, are made available to participants on a confidential basis, address default and non-default losses and provide resolution authorities with appropriate flexibility to determine the entity to be put in resolution. In addition, CCP resolution plans should not interfere with the resolution plans of clearing members, or lead to contagion in other services or segments cleared by the CCP, and should minimize risks to market

participants and the broader financial system. CCP resolution plans should also specify ex-ante resources for the recapitalization of the CCP with respect to both regulatory capital as well as default fund replenishment so that it can re-open for business and provide its critical services without taxpayer assistance[11].

The resolution regime in the US currently provides for CCPs to be resolved under Title II of Dodd-Frank, but it does not provide any further framework regarding the tools or resources that can be used to resolve CCPs. Further work needs to be done to confirm how a Title II resolution would be effectuated for the different ownership and capital structures of systemically-important CCPs.

Recognizing the need for greater prescription, the Financial Stability Board (FSB) is expected to consult later this year on further guidance on strategies and tools for CCP resolution, such as the resources that can be used, the structure to be adopted, the legal framework to be applied, the authority responsible for resolution, and cross-border coordination issues in the context of a CCP resolution. US regulators should issue new guidance in line with the FSB's recommendations, which would also support future equivalence discussions with various jurisdictions.

II. Capital Constraints are Reducing Access to Clearing for Market Participants

This Committee and the CFTC should be complimented for their leadership in examining the impact of the leverage ratio on the cost of clearing for end users and other market participants. Clearing members are fully responsible to the CCP for the performance of the transactions they clear for their clients, and clearing members collect margin from those clients to offset their exposure to them. The margin collected by clearing members is segregated from our own funds as required by the Commodity Exchange Act and firms cannot leverage it.

The Basel Committee's leverage ratio proposal, however, does not recognize the exposure reducing effect of the margin collected, and does not allow firms to offset off-balance exposure arising from client transactions against the value of the margin maintained in segregation.

This approach creates a disincentive for many clearing member banks to offer clearing services due to the higher capital requirements, a result at odds with the G20 mandate to move more derivatives into central clearing. End users are already seeing the effects of this approach, as there are fewer banks offering clearing services and end users are already seeing the price of clearing increase[12].

In its recent consultation regarding revisions to the leverage ratio, the Basel Committee did seek input from stakeholders regarding the impact of the failure to recognize initial margin as an offset, on the cost

[11] The Clearing House and the International Swaps and Derivatives Association recommended in a recent industry paper that authorities should consider the "implementation by CCPs of arrangements to maintain replenishment resources that could be used to backstop the timely replenishment of the default fund on an interim basis (or any failure of a clearing member to perform its replenishment obligation)."

[12] http://www.sifma.org/issues/item.aspx?id=8589958563; http://www.commoditymkts.org/wp-content/uploads/2015/11/CMC-MFA-Leverage-Ratio-Letter-End-User-Impact-Final.pdf

of clearing. An industry-wide response is being prepared to demonstrate the reduction in access to clearing for end users, and we appreciate and look forward to the continued support of this Committee.

III. Mutual Recognition of CCPs is Key to a Global Derivatives Market

The G20 leaders' 2009 agreement on derivative reform included a commitment to undertake reform without causing market fragmentation. This is an important goal given the global nature of the derivatives market. In practice, despite common objectives, technical and legal differences in national rule implementation have led to concerns around regulatory conflicts, inconsistencies, arbitrage, gaps and duplicative requirements which could undermine this goal. Subsequent G20 communiques have emphasized the need for regulators to address these issues.

The lengthy negotiation between US and EU authorities on EU recognition of US-based CCPs regulated by the CFTC illustrates the challenges faced. Policymakers had struggled to reach agreement due in part to differences in the applicable initial margin regimes in each jurisdiction. Following negotiations lasting over two years, in February 2016, the CFTC and European Commission announced a "Common Approach" regarding requirements for CCPs[13]. This was a welcome development, alleviating prolonged uncertainty which had been detrimental for market participants in the US and EU, as well as in other jurisdictions seeking recognition in these markets.

The agreement between EU and US authorities is critical to mitigating unnecessary reductions in cross-border trading and market liquidity by ensuring market participants across both continents have continued access to CCPs in each other's markets, and to prevent European banks from facing punitive capital requirements for exposures to US-based CCPs.

The process will help to instruct and streamline future equivalence and substituted compliance determinations between US, EU and other authorities, particularly with respect to equivalence for trading venues and substituted compliance for clearing, trade execution and margin requirements, to ensure that derivative markets remain global, liquid and resilient. It is important that regulators focus on thematic and outcomes-based determinations, rather than pursuing a granular element-by-element approach. It is also important to recognize that markets are global and that the global economy benefits most if capital is able to freely flow across those markets.

<u>Trade Execution and the Implementation of the SEF Mandate</u>

I. Evolution in Swaps Execution

Title VII of the Dodd-Frank Act established a comprehensive regulatory framework for swap trading platforms with the intent of furthering two policy objectives: 1) increasing pre-trade transparency to market participants before the point of execution; and 2) promoting trading on regulated exchanges. To achieve these objectives, Title VII created new types of trading facilities for swap execution known as

[13] http://www.cftc.gov/PressRoom/PressReleases/cftc_euapproach021016

swap execution facilities ("SEFs"), established core principles for the orderly and efficient operation of SEFs and introduced a requirement that certain swaps subject to the trade execution requirement in Section 2(h)(8) of the Commodity Exchange Act ("CEA") be traded on or pursuant to the rules of a SEF or traditional exchanges (designated contract market ("DCM")).

In June 2013, the CFTC adopted final rules that, among other things, defined which trading facilities and platforms must register as SEFs, established prescriptive requirements for SEFs to operate in accordance with SEF core principles and, although not expressly required by Dodd-Frank, created a process for determining which swaps are subject to the CFTC's trading mandate ("Mandated Swaps"). That process is commonly known as the ""made available to trade"" or "MAT" process. The CFTC's final rules' further required that all multiple-to-multiple trading platforms that list swaps to register as SEFs, even if those platforms do not offer Mandated Swaps for trading.

Since the CFTC's final trade execution rules came into force in October 2013 and the introduction of SEFs the CFTC's reforms have brought greater transparency, better price information and significant enhancements to market integrity. Notwithstanding these achievements, research shows that global derivatives markets have fragmented along geographic lines[14].

These rules require all electronic trading platforms that provide access to US investors for swap execution to register with the CFTC as SEFs. Under the CFTC's final rules, Mandated Swaps must be executed on a SEF or DCM through an electronic order book or a request-for-quote system that operates in conjunction with an order book.[15] This trading requirement has fundamentally changed the trading protocols and widely-accepted trading practices that were in place for market participants before the adoption of the CFTC's final rules.

In February 2014, the first series of swaps became subject to the CFTC's trading mandate. As of that date, all US persons (and non-US persons trading with US persons) had to trade Mandated Swaps on registered SEFs or DCMs and all SEFs and DCMs that listed Mandated Swaps were required to do so in accordance with the CFTC's final rules.

II. Market Impact of the CFTC's Final Rules

In effect, since the CFTC's trade execution requirements are restrictive and burdensome, non-US market participants are choosing not to trade on SEFs. In addition, since the CFTC has not establish a process of recognizing non-US trading venues that are subject to comparable regulatory oversight, US participants have limited access to these non-US based platforms and arguably non-US liquidity pools.

These unintended consequences are most evident in the global interest rate swap markets which have inhibited market participants from getting better pricing on derivatives resulting from varying levels of market fragmentation. This pattern is most persistent in euro-denominated interest rate swaps (IRS), where the vast majority of trading activity occurs between European dealers. ISDA research finds that

[14] https://www2.isda.org/functional-areas/research/research-notes/

[15] A request-for-quote system is a type of electronic bidding solicitation in which a requester (i.e., a client) seeks bids from several dealers to provide a price quote for the execution of a particular swap.

91.2% of cleared euro IRS activity in the European interdealer market was transacted between European counterparties in December 2015. In September 2013, immediately prior to the introduction of the SEF rules, this figure stood at 70.7%.[16]

Although concerns over best pricing have been discussed for almost three years, there are no signs currently that this trend is reversing. CFTC Chairman Massad's recent statements that suggest the CFTC is planning to make some adjustments to their final trade execution rules are welcome and important for promoting market efficiency. In this regard, market participants have put forth recommendations to improve pricing and restore liquidity in the derivatives markets, while still achieving the objectives of the reforms.

III. Market participants want additional choice in execution and greater flexibility in SEF rules

As noted above, the CFTC's final rules require SEFs to provide execution methods that may include either an order book (similar to an exchange) or a request for quote to a minimum of three participants. Many of our US clients want flexible trading requirements and protocols that will provide competitive and efficient execution based on the unique characteristics of a particular product.

The Dodd-Frank Act does not require that SEFs only execute transactions by means of an order book or a request-for-quote system to three. Such a restrictive interpretation contradicts Congressional intent to allow swaps to be traded by "any means of interstate commerce," discourages trading of swaps on SEFs and hurts pre-trade price transparency.[17] The CFTC's restrictive interpretation makes it difficult to achieve the broad goal of global swaps trading envisioned by the G20 member countries. In Europe, policymakers and regulators intend to allow derivative contracts that are subject to the trading obligation to be traded on a number of centralized venues, which offer more flexible methods of execution than provided for under the CFTC's SEF rules.

There are achievable ways in which to reduce the undesirable regulatory outcomes that threaten the efficient functioning of the swaps markets, reduce barriers to market access for US market participants looking to trade abroad and for non-US market participants wishing to trade efficiently in the United States, and minimize roadblocks to an effective cross-border regulatory regime, while preserving increased transparency and market integrity.

The CFTC should consider amending its rules to allow the CFTC, under certain circumstances, to approve additional methods of execution for Mandated Swaps. In addition, adjusting SEFs' execution models could facilitate a path toward achieving a substituted compliance regime for derivatives trading.

IV. The MAT process should give the CFTC decision-making authority with regard to products mandated to be SEF traded, and market participants should have the opportunity to provide input

[16] https://www2.isda.org/functional-areas/research/research-notes/

[17] 7 U.S.C. 1a(50) (2015).

Under the current MAT process, a SEF or DCM files with the CFTC, identifying the swap or swaps that will be subject to the CFTC's trading mandate. The only requirements or regulatory standards that the SEF's or DCM's analysis must meet are that: (1) the swaps in the submission must already be subject to mandatory clearing; and (2) the submission must consider one of six factors, broadly defined. Depending on the type of submission, in either 10 or 30 days following the official filing date, the SEF's MAT determination becomes law and applies to all SEFs, DCMs and market participants. SEFs are for-profit entities and this framework does not appropriately balance their commercial interests with the needs of market participants nor does it provide the CFTC with an adequate voice in the approval process. Specifically:

- The MAT process should require SEFs to provide a more granular explanation as to why a particular swap contains the requisite trading liquidity for mandatory trading. For example, SEFs should present additional quantitative and qualitative data as part of their MAT determination assessment.

- The public should be given the opportunity to provide comments to a SEF's MAT determination submission through a public consultation process.

- The CFTC and not SEFs should make the final decision as to when a swap should be considered to be a Mandated Swap.

- The CFTC should view a swap's availability for mandatory trading as a fluid determination. The SEF rules do not provide sufficient flexibility to both SEFs and SEF users to remove a certain swap from a MAT determination if the trading characteristics of the swap change such that it is no longer suited for trading through a SEF's order book or through a request for quote to three participants.

Market participants understand the CFTC is actively evaluating reforms to the MAT process and such refinements would be welcome.

IV. Trading venue equivalence will reduce the risk of further market fragmentation and promote trading liquidity between US and non-US markets

Other jurisdictions are at various stages of developing their own trade execution regulatory regimes. For example, the EU is in the process of developing its trading proposals, and its trading obligation is not expected to be implemented until 2018. Notwithstanding that foreign regulatory regimes are in their formative stages, it is encouraging that the CFTC has begun coordinating with foreign regulators to facilitate mutual recognition of trading platforms and trading requirements.

To reduce the risk of market fragmentation and to enhance trading liquidity between US and non-US markets, the CFTC should apply the principles outlined in the Final Report issued by IOSCO Task Force on Cross-Border Regulation and recognize and highlight the broad commonalities between the US and

foreign regulatory regimes, rather than focus on the more technical, line-by-line differences between the underlying rules.

The CFTC should compare its final trading rules with foreign regulations designed to achieve corresponding regulatory outcomes. Where these requirements are satisfied, the CFTC should provide that the foreign trading venues are exempt from SEF registration and compliance with the SEF rules, and that where a swap is subject to the CFTC's trading mandate, the parties to such a swap may satisfy the obligation to comply with the CFTC's trading mandate by executing such a swap on a foreign trading venue in accordance with applicable rules, regardless of their status as a US person or otherwise.

Congress directed the CFTC to exempt a trading venue from CFTC registration if the CFTC finds that the facility is "subject to comparable, comprehensive supervision and regulation on a consolidated basis by…the appropriate governmental authorities in the home country of the facility." This creates concerns about the competitive harm to American companies resulting from differences in final regulations, the gap in implementation dates in Europe and other jurisdictions as well as confusion over the extraterritorial application of these provisions. Congress provided the CFTC with broad authority to exempt platforms to adopt such a restrictive approach to mutual recognition. To that end, market participants see this authority as a helpful mechanism by which Congress intended the CFTC to pursue a more flexible approach based on global regulatory collaboration.

The work the CFTC and EU regulators have undertaken to date discussing these issues is important. In February 2016, both regulators announced the US/EU Common Approach, which market participants hope will result in greater harmonization of global trade execution standards.

Conclusion

We thank the Committee for the opportunity to share this perspective and we offer our assistance to policymakers in addressing issues that promote the viability of markets critical to end users and economic growth.

With the implementation of mandatory central clearing, CCPs have become an increasingly important component in the overall safety and soundness of the financial system. It is therefore critical that policymakers and market participants ensure the risk management frameworks in place at CCPs are sufficiently robust to reflect this enhanced role, particularly as central clearing is no longer optional for many market participants seeking to manage risk.

Similarly, it is important for regulators to review the various new requirements, with regard to both market reforms and new prudential standards, to understand any interconnections and ensure objectives are aligned. The leverage ratio's failure to recognize the exposure reducing effect of initial margin for client clearing is an example where regulatory objectives are at odds and it is already manifesting in reduced access to clearing services for some market participants.

Lastly, minor adjustments to the CFTC's SEF rules would support market efficiency, while maintaining the core objectives of enhanced transparency and market integrity.