

Second Treasury report issued: implications for derivatives market

December 06 2017 | Contributed by [Shearman & Sterling LLP](#)

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Introduction

On October 6 2017 the US Department of the Treasury released its second in a series of four reports (Capital Markets Report)(1) evaluating the US financial regulatory system.(2) This report follows on the heels of Treasury's first report on the US banking system(3) and addresses the US capital markets, including debt, equity, commodities and derivatives markets, central clearing and supervision of financial market utilities.

This update focuses on the recommendations relating to the derivatives markets.(4) In many cases, these recommendations reflect concerns identified by market participants in recent years, but do not propose fundamental changes in the overall post-Dodd-Frank Act derivatives regulatory structure. Most of the recommendations could be implemented through agency rulemaking, although a few would require congressional approval. The report also emphasises reconsideration of certain existing rulemakings in order to streamline regulation, generally without offering specific modifications or proposing a specific result.

Treasury breaks up its recommendations for the derivatives markets into several broad categories, including refinement of margin requirements, regulatory harmonisation, capital treatment of derivatives, end-user issues and market infrastructure. Treasury also provides recommendations on the supervision and use of financial market utilities (FMUs) and the structure and process of regulatory agencies.

Refinement of margin requirements

The report makes several recommendations concerning margin requirements for uncleared swaps which have been implemented in the United States and other jurisdictions beginning in 2016. These requirements marked a significant change in practice for many market participants and involved significant compliance efforts. The proposals reflect certain concerns that the margin requirements are too restrictive or may disadvantage US market participants when compared to their international counterparts. The recommendations include the following:

- US banking agencies should consider exempting transactions between affiliates of a bank or bank holding company from initial margin requirements for uncleared swaps;
- the Commodity Futures Trading Commission (CFTC) and US banking agencies should consider amendments to their rules to permit more flexible timeframes for collecting and posting

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- margin (a change particularly relevant for end users);
- the CFTC and US banking agencies should reconsider their overall approach to end users and reduce or tailor margin requirements using a more risk-based approach that takes into account the nature of the parties and transactions; and
 - the Securities and Exchange Commission (SEC) should re-propose and finalise its proposed uncleared security-based swaps margin rule,⁽⁵⁾ aligning it with the margin rules of the CFTC and US banking agencies.

US and international regulatory harmonisation

Under the Dodd-Frank Act, the swaps and security-based swaps markets were placed under the jurisdiction of the CFTC and the SEC, respectively. The Capital Markets Report urges greater harmonisation and coordination between these regulatory regimes. Specifically, Treasury recommends that:

- the CFTC and SEC conduct a joint review to harmonise their rulemakings and remove any regulatory redundancies and inconsistencies;
- the SEC finalise its proposed rules with regard to security-based swaps⁽⁶⁾ (which have not been fully implemented, unlike the comparable CFTC rules); and
- the CFTC simplify and codify all existing staff guidance and no-action relief intended to facilitate the implementation of the Dodd-Frank swaps regulatory framework.

Further, Treasury generally advocates for more cross-border harmonisation between US and international regulators, with the goal of avoiding market fragmentation, redundancies, undue complexity and conflicts of law. For example, Treasury recommends that:

- the CFTC and SEC reconsider whether counterparties, trading platforms and central counterparties in jurisdictions compliant with international standards should be forced to register with the agencies;
- the CFTC and SEC reconsider their controversial proposals that US derivatives regulations should apply to transactions between non-US firms or between a non-US firm and a foreign branch or affiliate of a US firm, in cases where US-located personnel arrange, negotiate or execute the swap;⁽⁷⁾
- US regulators work with regulators in other jurisdictions to remedy conflicting or duplicative regulation and develop more useful substituted compliance regimes; and
- international financial regulatory standard-setting bodies (eg, the Committee on Payments and Market Infrastructures and the Board of the International Organisation of Securities Commissions or the Basel Committee) further account for the views of external stakeholders, and that US members of standard-setting bodies provide a unified regulatory front in order to promote US financial regulatory objectives when developing international regulatory standards.

Capital treatment in support of central clearing

As expressed in the Banking Report, and consistent with criticisms from market participants, the Capital Markets Report reaffirms Treasury's concerns with the treatment of initial margin for cleared derivatives under the supplementary leverage ratio in the bank capital rules. The existing treatment of initial margin under the supplementary leverage ratio results in futures commission merchants incurring higher capital charges in their clearing services, which in turn may disincentivise the business of clearing derivatives and would run counter to the goals of the Dodd-Frank reforms. To address this issue in the short-term, the Capital Markets Report recommends deducting initial margin for centrally cleared derivatives from the supplementary leverage ratio.

In the longer term, Treasury recommends that regulatory capital requirements transition from calculating derivatives capital requirements from the Current Exposure Method presently being used to the Basel Committee's more recent Standardised Approach for Counterparty Credit Risk. The latter provides clearer offset for initial margin and recognition of appropriate netting sets and hedged positions. In addition, Treasury recommends that the US banking regulators frequently conduct assessments to see how capital requirements affect the incentives to centrally clear derivatives.

End-user issues and other clarifications

Treasury makes several recommendations directed at facilitating swaps trading activity by end users (ie, non-dealers) by easing burdensome regulatory requirements and providing regulatory clarity.

Specifically, Treasury recommends an amendment to Section 2(h)(7) of the Commodity Exchange Act(8) that would provide the CFTC with rulemaking authority to modify and clarify the scope of the financial entity definition. This authority would facilitate exemptions from the swaps clearing requirements for end users engaged in *bona fide* hedging or risk management and would provide the CFTC the flexibility to codify existing no-action relief.

The report also recommends that the CFTC maintain the \$8 billion swap dealer *de minimis* registration threshold, which was at the time of the report scheduled to be lowered to \$3 billion at the end of 2018.(9)

Additionally, Treasury recommends that the CFTC finalise its long-delayed position limit rule amendments,(10) taking into consideration hedging exemptions, manipulation risks and deliverable supply.

Trading market infrastructure

In terms of trading market infrastructure, the Capital Markets Report recommends as follows:

- the CFTC should consider rule changes that would permit swap execution facilities (SEFs) to use any means to execute swaps subject to a trade execution requirement, rather than being forced to use either an order book or a request for quote functionality;
- the CFTC should re-evaluate the process of determining if a swap is made-available-to-trade (a so-called 'MAT' determination) and thus subject to mandatory SEF trading, with the goal of not adversely affecting liquidity for swaps; and
- the CFTC should dedicate adequate resources to finish its Roadmap to Achieve High Quality Swaps Data(11) and leverage third-party and market expertise to develop an effective reporting regime.

Supervision and use of financial market utilities

The report acknowledges the significant role that FMUs play in financial markets and argues that their smooth operation is integral for maintaining a robust economy. Due to the interconnectedness of the systemically important FMUs (SIFMUs) designated by the Financial Stability Oversight Council, and the potentially dire consequences if one were to fail, the report supports enhanced risk management of SIFMUs. Accordingly, it recommends that:

- the Federal Reserve, the SEC and the CFTC dedicate additional resources towards the review of SIFMU rulemaking changes that could pose material risk;
- the Federal Reserve consider expanding Federal Reserve deposit account access for certain FMUs with substantial US clearing business market share that do not have such access. FMUs would nonetheless not be able to anticipate emergency liquidity from the Federal Reserve in their risk management planning; and
- the Federal Reserve review whether the interest rate paid on SIFMUs' deposits at Federal Reserve banks should be adjusted (ie, lowered) in light of comparable private sector rates.

In addition, Treasury recommends additional work on planning for liquidation and resolution of SIFMUs, which reflects a concern that strategies to date have been subject to only limited stress testing related to credit risk and certain default-related liquidity risks. The report recommends that:

- supervisory stress tests for SIFMUs be expanded to incorporate additional products and other stress scenarios, and should test for liquidity, operational and cyber risks;
- the CFTC and the Federal Deposit Insurance Corporation continue to coordinate on recovery wind-down strategies for SIFMUs in the event of a crisis and should work with international counterparts to focus additional recovery planning efforts towards non-default scenarios,

- such as cyberattacks, custodial failures or investment losses; and
- US regulators continue to take part in cross-border crisis management groups to coordinate cross-border resolution of central counterparties and should continue to promote US interests internationally when engaging with international standard-setting bodies such as the Basel Committee.

Regulatory structure and process

The report contains several recommendations to make the regulatory process more flexible and advance the goals of stimulating economic opportunity and providing greater clarity to market participants:

- the CFTC's exemptive authority under Section 4(c) of the Commodity Exchange Act(12) and the SEC's exemptive authority under Section 36(c) of the Exchange Act(13) should be restored to permit exemptions from the Dodd-Frank requirements;
- use of regulatory cost-benefit analysis should be enhanced. Agencies should make better use of their ability to solicit public comment, including use of advanced notices of proposed rulemaking;
- the SEC and CFTC should conduct periodic reviews of agency rules;
- the agencies should avoid imposing new requirements by no-action letter or informal guidance; and
- the CFTC and SEC should conduct comprehensive reviews of the roles, responsibilities and capabilities of self-regulatory organisations (SROs) and use the results to make improvements to the SRO framework, focusing on compliance, transparency and appropriate limitations. The CFTC and SEC should develop any rules needed to enhance SRO oversight and should require SROs to adopt and publicly release action plans to review and update their rules, guidance and procedures on a periodic basis.

Comment

As it relates to the derivatives markets, the Capital Markets Report does not advocate fundamental changes in the regulatory framework but suggests a change in regulatory emphasis. The report makes a series of specific recommendations that broadly would make incremental improvements suggested by market participants. Many of these changes could be made through agency action, and in some cases the relevant regulators have indicated that they are considering the same or similar proposals. Market participants should continue to monitor how the US federal regulatory agencies will respond in light of this report.

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Endnotes

- (1) The Capital Markets Report is available [here](#).
- (2) The Treasury review is intended to align with the Executive Branch's Core Principles for Regulating the United States Financial System, as set out in Executive Order 13772, available [here](#).
- (3) The Banking Report is available [here](#).
- (4) This update supplements our previous overview of the entire Capital Markets Report, available [here](#).
- (5) Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers, 77 Fed Reg 70213 (November 23 2012), available [here](#).

(6) Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 Fed Reg 29959 (May 13 2016), available [here](#); and Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, 81 Fed Reg 53545 (August 12 2016), available [here](#).

(7) The CFTC's proposed rule, Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed Reg 71946 (October 18 2016), is available [here](#); and the SEC's proposed rule, Security-Based Swap Transactions Connected With a Non-US Person's Dealing Activity that are Arranged, Negotiated, or Executed by Personnel Located in a US Branch or Office or in a US Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed Reg 8597 (February 19 2016), is available [here](#).

(8) 7 USC § 2(h)(7).

(9) Shortly after the Capital Markets Report was published, the CFTC issued an order delaying the scheduled lowering of the *de minimis* threshold from December 31 2018 to December 31 2019, available [here](#).

(10) Position Limits for Futures and Swaps, 76 Fed Reg 71626 (November 18 2011), available [here](#).

(11) More information regarding the CFTC's Roadmap to Achieve High Quality Swaps Data is available [here](#).

(12) 7 USC § 6(c).

(13) 15 USC § 78mm.

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