CFTC Chairman Concerned by Potential Impact of Capital Rules on Clearing Firms

Tim Massad, chairman of the Commodity Futures Trading Commission, told U.S. lawmakers that he is concerned about the impact that new capital requirements will have on central clearing. The CFTC chairman pointed in particular to the supplemental leverage ratio rule finalized last September by U.S. banking regulators, which does not exclude customer segregated margin from the calculation of capital charges on banks that provide clearing services.

"I'm very concerned that this could have a significant negative effect on clearing," Massad said at a Feb. 12 hearing of the House Agriculture Committee. "When it comes to margin that is legally segregated [and] that is not available to a bank for any other purpose, that should be treated differently in my view."

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> Chairman, CFTC

Massad added that he has spoken about this issue with officials at the Federal Reserve and other banking regulators. In September, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation approved the final rules, which modify the way leverage ratios are calculated and do not exclude customer segregated margin. This new leverage ratio calculation is set to take effect in 2018.

Similar concerns have been raised by two senior members of the committee—Representatives Mike Conaway (R-Texas), the chairman of the House committee, and Colin Peterson (D-Minn.), the committee's ranking Democrat. The two lawmakers sent a letter to Federal Reserve Chairman Janet Yellen and other banking regulators on Feb. 5 saying that the supplemental leverage ratio rule effectively misinterprets the exposure-reducing effect of segregated margin and will have "materially adverse consequences" on cleared derivatives markets.

"Many prudentially regulated entities may find this unwarranted capital treatment grounds for discontinuing their customer-facing clearing business," the lawmakers warned. "The resulting consolidation among FCMs would undermine key market reform principles of encouraging derivatives clearing and mitigating systemic risk."

U.S. Regulators Advance on Benchmark Reforms

U.S. regulators are pushing ahead with benchmark reform, working with the private sector on a two-track strategy to improve the methodology for setting Libor and develop alternative interest rate benchmarks.

On Jan. 20, Federal Reserve Governor Jerome Powell said in a speech that the Fed has convened an "alternative reference rate committee" comprised of large global dealers to help promote alternatives to U.S. dollar Libor. Powell gave no details on the committee's agenda or action plan, but stressed that Libor continues to suffer from "structural problems" despite recent reforms. A day later, the Financial Stability Oversight Council, a group that brings together U.S. regulators, discussed the current state of benchmark reforms at an open meeting chaired by Treasury Secretary Jack Lew.

The group reviewed the need for alternatives to Libor and discussed the formation of the alternative reference rate committee. A staffer briefing the group commented that the reforms to Libor have made it harder to manipulate the benchmark and noted the challenges of transitioning away from Libor but indicated the need for alternatives from which the market could choose. The staffer also commented that alternative benchmarks must meet IOSCO standards.

Additional Funding Sought for CFTC

In its proposed budget for fiscal 2016, the White House asked Congress to provide $322 million for the Commodity Futures Trading Committee, an increase of $72 million from the level approved by Congress for fiscal 2015. The president's plan, which must be approved by Congress, would also authorize the CFTC to collect a user fee "equal to the agency's annual appropriation."

CFTC Chairman Tim Massad testified on his agency's funding needs at a Feb. 10 hearing of a House Appropriations subcommittee. He urged the lawmakers to support additional funding for the CFTC to fulfill Dodd-Frank, strengthen its oversight of derivatives markets, improve its market surveillance technology and deal with emerging issues such as cybersecurity.

Representative Robert Aderholt (R-Ala.), the subcommittee's chairman, challenged the request for additional funding. Aderholt pointed out that the CFTC's funding has grown much more rapidly than what has been provided to the rest of the government and said the CFTC's budget should stay at its current level.

Several Democrats on the subcommittee defended the funding request, however, and asked Massad whether the CFTC could be funded through user fees. Massad responded that user fees could be applied without harming liquidity and noted that many other regulators are funded this way.

"We've looked at this. We think it's practical. Every president since Ronald Reagan has proposed it. So I'd be happy to work with the committee if you wish to explore that. I will say that, my primary goal here is to increase the budget. And if you want to do it through user fees, that's great. I'll work with you on that," he said.

The president's budget proposal also calls for a change in the tax treatment for derivatives, requiring transactions be marked to market, but without the current 60/40 tax treatment under which gains or losses on such transactions are taxed as 60% long-term capital gain/loss and 40% short-term capital gain/loss. Under the president's budget plan, gains or losses would be treated as ordinary income or losses at the end of each year, even if the actual gains or losses had not been realized. This proposed tax treatment would apply to derivative contracts entered into after Dec. 31, 2015.

The budget proposal also would levy a seven basis point fee on the liabilities of large, highly leveraged financial institutions. The White House estimated that this would raise $112 billion over 10 years by imposing the fee on roughly 100 firms with assets over $50 billion. "Alongside capital requirements and other tools that help rein in excessive leverage, a financial fee would improve economic stability by attaching a direct cost to leverage for large firms," the budget plan stated.

FIA PTG Offers Recommendations for Simplifying Equity Markets

The FIA Principal Traders Group released a position paper on Jan. 28 offering several recommendations on how to simplify the U.S. equity markets. The paper was submitted to the Securities and Exchange Commission and members of Congress as part of an on-going dialogue on market structure reform.

The FIA PTG paper calls for a modernization of the SEC's Regulation National Market System by eliminating the trade-through rule and the requirement to avoid displaying locked and crossed markets. The paper also calls for enhancements to broker best execution requirements and updates to certain disclosures.

"Our simplification proposals would reduce costs for investors, make markets more transparent, and increase investor confidence," said Richard Gorelick, a member of FIA PTG's executive committee. "Simplification must be a foundational principle in the current debate on equity market structure reform."

CFTC Grants More Time for OCR Reporting

The CFTC's division of market oversight issued a no-action letter on Feb. 10 that provides market participants with more time to comply with new requirements for ownership and control reporting. CFTC staff granted the extended relief in response to requests made by FIA so that clearing members, customers and swap execution facilities can develop the reporting systems necessary for the industry to comply with the OCR requirements.

FIA Comments on CFTC's Proposed Position Limit Rules

On Jan. 22 FIA submitted a comment letter to the Commodity Futures Trading Commission on the agency's proposed position limit and aggregation rules. The letter was submitted after the agency held a day-long discussion on the rules during a December meeting of the Agricultural Advisory Committee and later requested additional comments.

FIA commended the CFTC for making "important modifications" to the proposals, but encouraged the CFTC to implement the rule in phases and make additional changes to minimize the impact on commercial hedgers.

The recommended changes included:

- Setting hard limits only for spot months and rely on exchanges to set position accountability levels for non-spot months;
- Providing the industry with nine months to comply with the rules once finalized and coordinate implementation with European regulators as they establish a position limits regime in Europe;
- Expanding the definition of *bona fide* hedging to include common risk management practices used by commercial enterprises and permit exchanges to grant hedge exemptions, subject to CFTC review; and
- Relying on exchanges to estimate deliverable supply.

The CFTC is expected to finalize the rules sometime this year. In Feb. 11 testimony before Congress, CFTC Chairman Tim Massad told lawmakers that the agency is carefully reviewing comments before moving forward. "We are very focused on this. Congress mandated that we set position limits for derivatives to curb excessive speculation. But Congress also made it clear we should make sure we allow for *bona fide* hedging. And we're taking our time to make sure we get this right," Massad told a House Appropriations subcommittee.

CFTC Issues Relief to Foreign IBs from Certain Financial Reporting Requirements

The CFTC's division of swap dealer and intermediary oversight in late January issued no-action relief to certain introducing brokers from net capital and financial reporting requirements. The conditioned relief permits foreign-domiciled introducing brokers to file reports using local accounting principles in the country where the IB is located instead of U.S. or international accounting standards. In addition, eligible foreign-domiciled IBs will not be required to apply certain foreign currency capital charges under the CFTC's Regulation 1.17. The relief also allows IBs to recognize as a current asset adjusted net capital receivable balances which are promptly billed and due from their over-the-counter swap customers.