

CFTC MARKET RISK ADVISORY COMMITTEE

OVERVIEW

For questions on the note below, please contact [Kwon Park](#) at (202) 547-3035.

Today, the CFTC held a meeting of its Market Risk Advisory Committee (MRAC) to describe and discuss 1) how effectively end-users and other market participants, in different asset classes are able to find counterparties for transactions, receive accurate pricing and volume information, and otherwise access the markets; and 2) the extent and nature of the current use of portfolio compression and related services, and the benefits and challenges posed by portfolio compression activity in the derivatives markets.

Please click [here](#) for the agenda.

Key Takeaways

- Some Committee Members disagreed on whether post-trade anonymity on swap execution facilities (SEFs) was necessary as it relates to the interest rate market, but generally agreed that package transactions still present challenges and operational complexities for SEF transactions.
- Commercial end-users stressed that the utilization of SEFs will not immediately occur due to cost burdens and the threat of registration. They indicated that while an electronic marketplace presents many benefits, smaller firms face operational complexities, increased costs, and additional staffing risks.
- An Ag Member said that the introducing brokers (IBs) providing them access to the market face challenges with the increase in recordkeeping requirements and the lack of futures commission merchants (FCMs) available.
- On portfolio compression, panelists said registration is unwarranted for third-party compression service providers and that this service is purely analytical and reduces risk through means other than the reduction of gross notional and line items.

SUMMARY

Opening Statements

[Chairman Tim Massad](#)

- Interested to hear how derivatives markets are working, particularly for commercial end-users.
- Hopes the Commission will consider codifications to recent SEF modifications to enhance SEF trading and participation.
- Look forward to learning about portfolio compression strategies and the implications of those strategies.

[Commissioner Christopher Giancarlo](#)

- Trading liquidity has fundamentally changed in many financial markets. Quantifying liquidity is challenging, but it is not impossible. Liquidity can be quantified by looking at market depth, volume,

immediacy, participation, and turnover.

- Uncoordinated policies by U.S. banking and international regulators pose significant risks to liquidity. Prudential regulators should think about the amount of capital constraints they are placing on firms and its impact on vibrant capital markets.
- Treating swaps created by compressing legacy swaps as new swaps is inconsistent with no-action relief that applies to clearing for amended or replacement swaps generated as part of a multilateral portfolio compression exercise and are subject to required clearing.

Commissioner Sharon Bowen

- Our markets have gone a transformational change in how they function. Interested in hearing about market participant's ability to access liquidity, effectively hedge, and allow for accurate price discovery – specifically:
 - How market participants are using permanently registered SEFs and how to improve the way they function;
 - The role of IBs and how they are utilized with major changes in our markets;
 - How technology has altered ways market participants access various markets and the risks it introduces; and
 - The level of volatility and liquidity in our markets.

How Are Market Participants Accessing the Derivatives Markets Today?

Moderator: John Nixon, ICAP

Rates/ CDS

Rana Yared, Goldman Sachs

- CDS markets, unlike rates, do not have an alternative liquid hedging instrument in futures – CDS markets are fully anonymous on a pre- and post-trade basis. SEF execution has been beneficial in more volatile conditions. Order book trading in credit index swaps represent the start of a greater trend.
- Package transactions present challenges and operational complexities for clients.
- In rates markets, clients still trade in request for quote (RFQ) fashion to hedge their exact risk, and they benefit from relationships with various dealers. Interdealer brokers (IBDs) have naturally developed central limit order books (CLOBs) around benchmark points. Liquidity in interdealer markets have decreased in dollar and euro markets.
- The argument for fully anonymous pre- and post-trade order books is a red herring. Our clients in rates markets want to match specific cash flows (bespoke trading) which can only be done in an RFQ model.

Kristen Walters, BlackRock

- Proper functioning of central credit products is essential to functioning fixed income markets. Regulatory changes have not created a liquidity crisis, but fundamentally changed both the derivatives and bond markets – changes which were necessary for the current market infrastructure.

- BlackRock has fundamentally changed its trading approach, acting more as a price maker and breaking up trades into smaller sizes.
- The made available to trade (MAT) process needs work, trade execution in particular. SEFs are improving transparency, but they add operational complexity for smaller market participants. The need to connect to multiple SEFs is expensive from an infrastructure perspective for smaller firms.
- Encourage a permanent regulatory framework for package transactions – a transaction should not be subject to the trading mandate because one product in the package is a mandated product. The focus should be on the entire package.
- Important for properly functioning credit markets to have both index and single name CDS.

Luke Zubrod, Chatham Financial

- In SEF traded cleared swaps, bid/ask spreads have narrowed significantly, competition has become easier, as well as contract termination. The benefits come at the cost of funding initial margin (IM) and clearing related fees. These costs are overwhelmingly negative for market participants with smaller trading volumes.
- The Commission should exempt financial entities transacting a *de minimis* amount of swaps to address uncertainties resulting from regulations.
- Pricing for longer dated swaps have materially increased and capital charges have increased these costs.
- Negative interest rates and negative swap spreads due to prudential regulations have been problematic for end-users.

Energy

Glen Mackey, NRG Energy

- Energy swaps have largely moved into futures markets. SEFs present operational complexity, increased costs, and additional staffing risks. End-users are accessing financial energy markets through electronic brokerage firms and using IBDs via voice lines.
- Electronification has decreased the need for dealers and market liquidity has decreased dramatically.
- The Commission should remove swap data reporting requirements on end-users.

Jerry Jeske, Commodity Markets Council (CMC)

- Utilization of SEFs by ag and energy firms will not immediately occur because of registration and cost burdens (i.e. 1.35 recordkeeping requirements).
- The electronic marketplace is good because it eliminates the middlemen, but brokers are helpful and necessary in bilateral transactions. Small farmers may not have electronic markets available to them. Regulation Automated Trading (Reg AT) threatens electronic trading participation.
- The Commission should address the swap dealer (SD) *de minimis* level. SD registration is an added cost firms cannot determine.

Agriculture

Tom Coyle, National Grain and Feed Association (NGFA)

- IBs service smaller market participants, but they face challenges due to increased recordkeeping and less FCM access.
- While order entry has improved due to electronic advancements, IBs have trouble finding FCMs to accept their business. The drop in the number of FCMs is due to increased regulations, risk of fines, cyber threats, and audits.
- Electronic trading has made actual hedging less significant and relevant for pricing. Commercial hedgers are at a disadvantage because of speeds and the lack of real-time enforcement that was available in a pit environment.
- The Commission should:
 - Enhance transparency by requiring detailed disclosures of trade depth and trader identities;
 - Require 2-3 seconds of stay for algo trading orders so orders cannot be pulled before execution; and
 - Implement a broader definition of *bona fide* hedging.

Foreign Exchange

Angela Patel, Putnam Investments

- Currency forward contracts are still mostly governed by ISDA documents.
- SEF rulebooks for non-deliverable forward (NDF) trading is problematic and the market has moved back to voice trading. This market has become more inefficient.
- NDF participants utilize either voice or electronic platforms depending on their feelings with SEF rulebooks. Because clearing is not mandated, pre-trade credit checks and other terms are still governed by ISDA and settled bilaterally.
- The FX market warrants less attention from the Commission. The lack of consistency in European and U.S. regulations are concerning.

Q & A

Massad: On Reg AT, the Commission is focused on the risk of market disruption. The proposal is designed to require reasonable risk controls as FIA PTG and other groups have identified as best practices. Electronic traders have actually asked to broaden the scope of controls because of risks smaller participants may pose.

Giancarlo: Will single name CDS come back into the market? *Walters:* Single name CDS is important as a hedging vehicle to complement what happens in index markets. If single name CDS clears along with index CDS at exchanges, liquidity might change.

Stephen Berger, Citadel: Challenges with liquidity conditions can lead to innovation. Three improvements can be made through innovation: firm prices, firm quotes in size, and reliability in volatile market conditions. Barriers exist to CLOB trading and we must address them. It is false to claim that post-trade name give-up is a red herring. The biggest barrier to market access is the economics of clearing.

Kim Taylor, CME Group: On Reg AT, regulators should approach market makers with caution – fewer market makers may impact liquidity and the price making function.

Sebastiaan Koeling, FIA PTG: Market makers try to make markets for end-users in a functioning market. On floor trading, why is it important to know who traded what? *Coyle:* Without knowing who traded what, we cannot measure actual commercial impacts on markets, such as pricing. Having more information will not hurt anyone and will help position our strategy.

John Nixon, ICAP: In the rates market, primary reason preventing end-users from using CLOBs? *Walters:* For smaller end-users, operational complexities exist. While BlackRock is willing to invest in connection to CLOBs, connection is very costly for smaller end-users.

Nixon: What are the impediments to CDS volume growth on SEFs (interest rate cycle, capital rules, etc.)? *Lee Olesky, Tradeweb:* Volume on SEFs have actually gone up tremendously. Capital constraints are impediments; *Nathan Jenner, Bloomberg SEF:* Product fungibility is a reason. One of the goals of SEF implementation was to facilitate more entrants into the marketplace and we have seen non-traditional liquidity providers make markets. We view this as positive and expected outcomes.

Nixon: OTC markets offer more venues to operate on and flexibility – any concerns with the lack of options (only CME and ICE) for trading on listed markets? *Mackey:* Yes, but the key is adequate price and liquidity. We are looking to hedge risks and to ensure we balance potential exposure to market events.

Dr. Marcus Stanley, Americans for Financial Reform: Recent NY Fed study revealed that liquidity has not declined in corporate bond markets. Another study found that 2/3 of energy companies use swaps for non-hedging and profit making purposes. End-users in the real economy have mechanisms through futures markets to manage their spending flows and do not have to rely on OTC derivatives markets.

Dr. Anat Admati, Better Markets: Liquidity is not a *per se* regulatory objective.

Portfolio Compression

Moderator: Edward Pla, FIA

Claire Lobo, Markit

- The goal of portfolio compression is to reduce overall market risk. Netting is a type of portfolio compression, to offset trades equally in a risk-setting manner.
- Compression provides the following benefits: reduced capital costs, proactive counterparty risk management, reduced operational risks and costs, fewer line items to manage in a default, easier facilitation of porting client trades, and reduced contagion and systemic risk.
- Innovation with respect to portfolio compression is good for the market.

Michael Modlock, TriOptima

- As a service provider, TriOptima and other third party compression providers are regulated. Our service does not provide a platform with bids and offers and does not reflect markets in real-time. This is a good reason for not requiring registration.
- TriOptima provides a purely analytical service and risk reduction through means other than just gross notional and line items.

Lucio Biase, LMRKTS

- Dynamic hedging reduces other risks such as systemic risk. Regulations should not stymie the goal of safety and soundness. Portfolio compression services are done in a controlled environment with complete transparency to regulators.

Dennis McLaughlin, LCH

- Portfolio compression provides notional and counterparty exposure risk reduction. Parties deal with less line items and trade reporting is made easier. Compression should be encouraged but not mandated.
- Challenges exist in treating swaps created by compressing legacy swaps as new swaps for margin purposes.

Kim Taylor, CME

- Compression activities are risk reducing and should be broadly available and expanded to include elements of the buy-side.
- Reporting requirements should err on the side of under-engineering versus over-engineering the exact specificity of every tiny feature of every trade in the marketplace.
- Given capital requirements set up to penalize the growth of risk exposure and the systemic benefits to the reduction of line items and counterparty exposures, the Commission should encourage compression activities that distinguish trades and reduce risks.

Q & A

Berger: Multilateral compression facilities have not been available to the buy-side using FCMs. For us, portfolio compression is done at SEFs with the goal of line item and gross notional reduction. Part 43 reporting (publicly disseminated information) must be tailored from a portfolio compression standpoint – important to flag package transactions.

Massad: We must be careful with exemptions - for example, clearing depends on the legacy swap, and once we get out of legacy world the clearing issue does not matter.

Yared: Compression tools are incredibly important from a dealer's point of view, providing gross notional and exposure reductions.

Stanley: Be careful about granting too many exemptions to models based on exposure reduction. Exemption may give a few parties a competitive advantage.

Susan O'Flynn, Morgan Stanley: We need to recognize efficiency in CDS and IRS markets with portfolio compression, but remember compression is not 100% successful for bespoke transactions.

Admati: Concerned about regulatory arbitrage with regard to compression – compression does not eliminate risk completely.