

Smart regulation

by Daniel P. Collins

After seven years of a consistent flow of new regulations, the trading world is not looking for more regulatory change, but a review of what is working and relief from what has gone too far — basically, a smarter approach.



With the Trump Administration sending out a clear signal that it is looking to reduce the regulatory burden on business, one can imagine that the trading world, which has spent the last seven years attempting to digest a flurry of new regulations, would be ripe with anticipation and demands to repeal much of the recent regulation.

But the Futures Industry Association (FIA) is not looking for a wholesale repeal of Dodd-Frank or other regulations — the work and cost of adjusting to new regulatory regimes is often more cumbersome than the actual regulations — but to tighten them up, modify their scope and make them smarter.

In an open letter to President Trump and legislative leaders, FIA President and CEO Walt Lukken called for a comprehensive review of all U.S. financial reform regulations. He pointed out that the Dodd-Frank Act has generated more than 22,000 pages of regulations and now is an appropriate time to review and simplify the regulatory framework developed following the financial crisis.

“While some elements of Dodd-Frank may warrant repeal, others simply require reform,” Lukken wrote. He went on to say that there needs to be a focus on smart regulation and enforcement.

Modern Trader spoke with Lukken regarding what should come next.



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Modern Trader: Many FIA member firms have been concerned about the implementation of Dodd-Frank, but also over general regulatory uncertainty. Now that the rule writing is mostly complete, are they looking for Dodd-Frank to be repealed or simply modified?

Walt Lukken: We wrote a letter to the President suggesting that certain aspects of Dodd-Frank may only require reform vs. repeal. Underlying that is the concept that [the industry] wants consistency, predictability and stability. That doesn't mean there are not changes that are necessary in order to make it more practical, more workable to grow our markets; but pulling the Act out by the roots may not be the right thing for our industry, so we suggested that we need to be looking at ways that we can avoid duplication and reduce cost. Clearing works and has worked for many years in our industry. That is an important concept to be consistent on.

MT: At the core of Dodd-Frank was adopting the regulated futures industry model of central counterparty clearing, right?

WL: Yeah, even before Dodd-Frank. Dodd-Frank didn't invent clearing. It expanded clearing into the [over-the-counter] world, but if you recall when Enron had its trouble years ago, clearing started to occur in the energy products at both Nymex and ICE and eventually the entire complex came into clearing without a legislative mandate. So I see Dodd-Frank as quickening the evolution of clearing in [derivatives] rather than mandating it. It quickened a lot of products into clearing to the benefit of our system. This was not a new thing, but [the 2008 crisis] expedited the process.

MT: Can you list the four or five top regulatory priorities of your member firms?


WL: Conceptually, before we get into specifics, we're looking to make regulation smart; regulation and enforcement. This gets at the concept of how to avoid duplication. Are there ways to do things to [achieve a] public good without certain costs? That can cover a variety of topics but as we look at reforming Dodd-Frank those [are the things] we look to tackle. Probably, the number one issue is capital. The vast majority of the volume in our industry goes through bank-owned FCMs that are now being taxed for the margin they carry on behalf of their customers as part of the lever-

age ratio for Basel capital requirements. We have pointed out to the regulators that we want things [to go into] the protected and systemically mitigating clearing system and capital [rules are] actually driving things out of it. If that can be fixed, the system will be safer, so that is an issue the whole community — whether it is the exchanges, the buy-side or the sell-side — wants. That is probably our number one issue.

But we have been working on a variety of other things: Reg AT is a big one, position limits, a lot of reporting issues both in Europe and the United States, the ownership and control reporting (OCR) has been a big one in the United States. Those are some of the main issues that are currently on our plate. But our hope is that with the President asking for a review of all financial reform regulations during the next 120 days, that we can help identify things that make the system smarter. Not repealing it, but let's make it smarter and work better and some of these current issues may be a part of that too.

MT: On Reg AT, are regulators overstepping their bounds by demanding proprietary information from traders without a subpoena?

WL: For us, we wanted to make sure that we identified the problem and identified the risk they are trying to [resolve]. We've always felt that there is an ability and need for regulators to get that information when they need it, but it should be at a high bar given the sensitivity. The fact that this is the lifeblood of many of these companies; in essence it is the formula for Coke that is closely guarded by the Coca Cola Corporation, that is what drives the value of these companies. We have already seen letters to senators about the technology problems at the Commodity Futures Trading Commission (CFTC). So I don't think it has been proven that this information couldn't get into the wrong hands, so there should be a high bar — a subpoena — to get that information. They certainly should be able to get it in a time of crisis after an event has occurred so that they can address the problems that they are trying to fix.



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MT: On position limits, do you just want them gone? It has been a long slog going back to claims that a lack of hard limits caused the crude oil spike in 2008.

WL: Position limits have been in place for a long time, they're not new to our industry. They are very effective in the spot month for preventing a squeeze on delivery. We have seen less effectiveness in the out months in trying to avoid excessive speculation, so there is a role for position limits, but they should be smart about it and what we have tried to do is to give them ideas on how to make that smarter. The exchanges need a strong role in position limits; to be involved in what those limits should be because they are the ones closest to the market. There is a role for accountability levels; these are the concepts we have been trying to articulate to the CFTC. Businesses need the ability to hedge. That is the essence of making sure position limits allow people to hedge underlying exposure. There is a way to balance that.

MT: Where did the various iterations of this rule go wrong?

WL: A lot of our users talk about anticipatory hedging. That is a tool they use to manage their business. Typically these are not folks we would call speculators, they have physical businesses that they are trying to manage and that type of hedging has been a tool that they used and that is something the CFTC has been strict on and we would like to see them review that.

MT: Is the capital rule part of Dodd-Frank or related to Basel?

WL: That is a Basel rule. Basel was supposed to finalize that rule in January at what they call the GHOS (Group of Governors and Heads of Supervision). It is the Central Bank governors and finance ministers from around the world that get together and can bless that international standard. Because of the election and because the Europeans are probably going in a different direction on this issue, they have delayed that meeting. What happens is the prudential regulators (Federal Reserve, the OCC, FDIC) take those standards and implement them in the United States. There are several levels in which we can hopefully influence and make our case. One is at the international level, which has not been finalized but may be finalized in the coming months, and the next phase is when it is implemented — already Europe has indicated that it is going to recognize margin not as leverage, but


it's going to be an offset of capital, which is where we want the rest of the world to be. We are hopeful that the U.S. [regulators] understand and make those adjustments.

MT: Is the bottom line that banks are being penalized for doing the right thing by bringing trading into central clearinghouses?

WL: The margin that is held in an FCM is the customer margin, it is not bank leverage, they can't rehypothecate it, they can't leverage it and the vast majority sits with the clearinghouse. This is protected money, and because of those protections, it deserves not to be counted as leverage in capital calculations. We would like them to recognize that and have been working with the prudential regulators to do that.

MT: Is just the fact that there won't be any new rules a benefit to your members?

WL: Absolutely. There was a collective exhale that one change with this administration is just to take a pause and do a review of what we have on the table. This does not mean repeal, but it begs the question, "How do we get the seven years of independent rule makings that have occurred to work together?" Where would you make adjustments? The EU is already doing this. In its legislation it is required to take a pause and look at the rules. That is all we are suggesting here. What is working? What is not working? How do we adjust? Let's make it work as a whole system. Because it wasn't designed as a whole system, it was implemented individually, but the cost now is being felt collectively by our members.



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MT: Are you concerned about the shrinking number of FCMs?

WL: Having a healthy robust FCM community is healthy for the marketplace. It is like any ecosystem. If you limit the frogs then the birds don't eat and so on. We need, and the FIA's mission is, fair competition. We want a lot of people competing because that drives innovation, that lowers cost, it better socializes risk within the system; the liquidity that is brought in by that improves price discovery. Shrinking FCMs? I don't think there is a good way to spin that; we want as many FCMs in our industry as we can and we want to be able to compete on a fair basis.

MT: Some FCMs have suggested that the resultant consolidation in the FCM space following the credit crisis has been good because what is left are firms on solid footing?

WL: Inevitably, competition can drive out members that don't have the best cost structure or aren't good business people. If that is the case that is just business, that is what competition drives. But the fact that it is regulation that is driving people out of business is not a good thing. It should be the marketplace that weeds out individuals because of their practices, not regulation. We've always been a supporter of getting as many FCMs into the system and competing. Let the good ones rise and the bad ones fail. That is the free market.

MT: How do you stop the trend?

WL: If you can rationalize the business model and get rid of some duplicative regulation, others will start to eye the space. We have had four or five large, well-resourced entities get out of the swap clearing business over the last five years, most recently Deutsche Bank getting out and this capital issue as one of the reasons. If we can address those things, you will see some larger entities getting more competitive in that space, deciding to invest resources and you may see some non-bank FCMs come into the business. You may see more if the fixed regulatory costs become stable. People will start to invest and see some advantage in getting back into our markets.

MT: Higher interest rates may help as well.

WL: Yeah. Interest rates always helps the FCM community, they earn interest off of the customer segregation.

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MT: In recent years, FIA has transformed itself into an international trade group. What have you learned based on this transition? How has your mission changed?

WL: We reflect our membership's needs. Our membership was becoming more and more global and we have to reflect [that in] our organization in order to service our membership. Either our members are global entities or they have offices around the world, or they need access to global markets. Either way, people felt the FIA's mission should represent broader than a domestic [focus]. We had been partnering with our friend the [London-based Futures & Options Association], but over time it made sense because we had a common membership. There were a lot of synergies we could bring to the marketplace and that led us to, three or four years ago, [discussing a] merger, which happened in January of this year. Hopefully, when you read our

KEY REGULATORY FIXES

While not looking to repeal Dodd-Frank the FIA would:

- Reform Basel Capital rules on banks to take away disincentive for cleared products.
- Reject Reg AT provisions that would give access to proprietary trading systems to regulators without a subpoena.
- Adjust position limit rule to focus on spot month and allow for anticipatory hedging.
- Adjust the ownership and control reporting (OCR) rules that have extremely low thresholds requiring additional record keeping and requiring the CFTC to safeguard customer information.
- Eliminate duplicative rules that adds costs to the industry without making it safer.



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materials, you’ll see that they are resources, that there is an offering of value no matter where you are located around the globe. A lot of the products we offer are not limited to one location. Whether it is documentation or [global futures] volume data or FIA technology; these are global products that we offer our industry no matter where they are located, and there is value in that.

MT: What is the state of international regulatory cooperation? Has it improved?

WL: It has. Certainly, after the financial crisis there was a bit of a retraction of cooperation among the financial community just because everybody started to take care of their own jurisdictions, and focus on how they can fix what they perceived as broken in the marketplace. Over time people quickly came back and realized that there needs to be strong international coordination, that the markets truly are global and we need some way to conduct cross border business going forward. There has been a lot of attention on how we can recognize and grant equivalence to different jurisdictions to allow citizens of one country to access markets of another country. We have been progressing at a good pace over the last several years, most recently with the EU recognizing our U.S. CCP equivalent, but this is going to be an ongoing issue post-Brexit. As the EU figures out its relationship with Britain that may affect the EU’s relationship with us and the EU’s relationship with Japan and the EU’s relationship with countries around the globe. We’re closely monitoring that; that there is fair access, fair competition, that we will all have the same rules.



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MT: The new administration has promised to reduce the regulatory burden; it also has advocated some protectionist-type policies. Are you concerned about this?

WL: What we are asking for is fair trade. Fair access. Fair competition. If you can structure this correctly there are ways to make sure that our markets are protected and that our customers here in the United States have access in a fair way to global markets and vice versa. Our figures show that roughly 37% of customer funds held in segregation come from outside the U.S. banking system. That is a big chunk of money coming into the United States, on U.S. exchanges, to provide liquidity and protections for the marketplace and I suspect that those figures are equivalent [to those] in the other direction: that the U.S. customers are providing a great deal of the volume and customer funds in Europe and Asia. We think it is really important to make sure that this Administration, the Europeans and others understand the importance of access to global markets and how to make sure there is a system in place to grant that access.

MT: Is this anti-globalist movement a concern because it is occurring while you are becoming more international?

WL: I know there are different ways to look at this but I do think it is about having fair access. The key word there is that it is fair. The administration seems not [to be rejecting] trade deals, but that they want better trade deals. I don’t think that it is necessarily anti-globalist. Some of these things are in need of review anyway. We want to be a part of that dialogue. If they decide to look at financial services and there is a way to grow the pie to the benefit of the United States [but also] to the benefit of global markets by allowing for that kind of access. We are here to beat the drum on that issue and are willing to work and engage with the administration on that front.

MT: Is that the same perspective of your European and Asian members? This anti-global sentiment is a global phenomenon.

WL: We always have to look out for unanticipated events, but that should not change our mission. We have strong principles on what we stand for, and making sure there are strong global markets is a big one for us. We are not going to shy away from that fact. We hope that our data and our experience in that area can help inform the debate. Make sure they are on the right track. ▲