

Implementing the Dodd–Frank Act: Progress to date and recommendations for the future

Scott D. O’Malia

I know that I don’t have to tell you that the Commodity Futures Trading Commission (CFTC) has been extraordinarily busy in its efforts to fulfill the regulatory mandates of the Dodd–Frank Wall Street Reform and Consumer Protection Act. As of May 2011, the CFTC has put forth 66 proposed and final rules under the Dodd–Frank Act. Not even counting the last four rule proposals the CFTC voted on, we’re at over 1,046 dense *Federal Register* pages filled with legal jargon and regulatory requirements. If you were to run the comment periods on all of those proposals consecutively, it would take 2,964 days, or a little over eight years. I doubt I have to give those numbers much context; they speak for themselves. But just for fun, if you were to lay each of those *Federal Register* pages end to end, they’d stretch two-thirds of the way up the newly renamed Willis Tower. And we’re not done yet, so I am sure we’ll reach the top of the tower before this is all over.

Sequencing and implementation

When you’re putting out that much paper, I think you should have a plan for how to get through it. We are nearly halfway through the rulemaking process and we are just about to start consideration of the final rules. As Winston Churchill once advised, “If you are going through hell, keep going.” I’m going to accept that advice, but I have made two recommendations for the chairman of the CFTC to make our trip a little better.

First, I have asked the chairman to put forward a provisional sequencing of the final rules to allow the market to comment on where you think we got it right and, of course, where we can do better. Second, and even more importantly, the CFTC should set an implementation schedule for all of the Dodd–Frank rules and publish it in the *Federal Register* for comment. This will allow the market to suggest changes to the schedule before the CFTC misses the mark. Market participants need to know when they will be expected to implement

the rules so that appropriate investment, staffing, and reorganization decisions can be made. Until a final schedule is published, market participants will continue to play a very high-stakes game of pin-the-tail-on-the-donkey. Providing an additional level of transparency is entirely appropriate. We have already conceded we can’t meet the deadline set by Congress in the first place, so providing a plan will not keep the CFTC from meeting that date.

CFTC–SEC roundtables

The CFTC and Securities and Exchange Commission (SEC) conducted a roundtable discussion on

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Dodd–Frank implementation in May 2011. From this discussion, I took away three very clear messages that the public was sending the CFTC.

First, market participants would like an implementation schedule so they can make investments to comply with the rules. Second, there is nothing the market can't build, integrate, and execute, but the CFTC must provide clear rules and enough time to implement the rules. The panelists made it clear they needed months, not years, to implement these rules. Third, phased implementation of the rules is essential to ensure that all the pieces work together.

What was not clear from this discussion, however, was the appropriate phasing. There was not consensus about whether we should start with participants, products, or both nor about how the CFTC will handle the challenges presented by the clearing mandate for standardized over-the-counter (OTC) derivatives. So, we have more work to do on this front. The ball is now in our court. The market has been frank about the challenges and has only asked for schedules, regulatory certainty, and patience.

Regulating the swaps markets

Still, we are making a good deal of progress in our rulemaking process. In fact, we are exceeding expectations. At the last CFTC open meeting, we finally released the much-anticipated joint proposal with the SEC on definitions of products, including swaps.¹ As you know, the CFTC had previously released proposals addressing the definition of swap execution facilities (SEFs), as well as the definitions of swap dealers and major swap participants. While we all share as common ground the goal of reducing systemic risk, we do have some differences of opinion as to the best way to meet that goal.

Swap dealer and end-user definitions

For example, I believe our proposed definition of swap dealer is too broad and will likely capture commercial entities that use swaps primarily to hedge their risks. As a result, these entities, which do not pose systemic risk, will see their costs go up. In contrast, the proposed definition of end-user was too narrow. That proposal even missed an uncontroversial opportunity to clearly exempt certain Farm Credit System (FCS) financial entities—or FCS banks—from clearing requirements. Congress made it clear that regulators were permitted to exempt these banks. The CFTC failed to make it clear that FCS banks' swap transactions would qualify for the bona fide hedging exemption.

Capital and margin

My concerns with the proposed definitions of swap dealer and end-user also have implications for the recently proposed capital and margin rules. For example, if the definition of swap dealer captures commercial end-users, then they will be required to take a direct capital charge for the credit and market risks associated with each swap they enter into with other commercial end-users. Also, there is no language in the margin proposal that makes it clear that end-users won't be assessed margin. Instead, the proposal states that each swap dealer may accept margin in a manner agreed to by the parties in a credit support arrangement. In stark contrast, the prudential regulators have put forward draft rules that prohibit bank swap dealers from posting margin to their counterparties and provide no capital threshold exemptions for end-users.

What does all of this mean? I believe costs for commercial end-users will increase. Congress did not want us to impose increased costs on commercial firms that are not systemically relevant and force those firms to decide between hedging risk and investing in their business. Unfortunately, I believe the draft rules ignored congressional direction.

Swap execution facilities

One element of the new market structure, which seems to have captured everyone's imagination, is the swap execution facility. This new exchange offers the best opportunity to improve swaps market transparency and improve our ability to manage risk with real-time pricing, contract standardization, and better liquidity. I am often reminded that the swaps market developed in parallel with the futures market because of the important differences in liquidity between those markets. A one-size-fits-all approach—namely, a central limit order book—will not work in the swaps market because it is less liquid. The CFTC's SEF proposal allows for both limit-order-book and request-for-quote approaches in order to provide flexibility and to encourage liquidity formation.

I believe the number and variety of SEF platforms in existence and under development highlight the innovative capabilities of this market and confirm that no technological challenge is too big for it. To highlight what the market is capable of when it is given clear direction, I hosted an SEF showcase back at the end of March 2011 at the CFTC headquarters in Washington, DC. I invited any organization that developed an SEF platform to participate and show off its technology. No one was turned away, and the exchange of ideas among the participants promoting 16 different SEF platforms, representing all asset classes, lasted all day.

I was impressed with how quickly and creatively potential SEFs met the proposed requirements outlined in the CFTC's rulemaking, but I think we need to continue to provide flexibility in our rules to allow SEFs to innovate and compete for business. Also, I want to make sure that without penalty this market can execute transactions of sufficient size to meet participants' needs. We've received feedback from the public that the requirement that bids for less liquid swaps are shown to at least five dealers and the requirement that any order be visible to the market for at least 15 seconds (as with SEC rules for other securities) would harm the market.

Technology

We have massive new responsibilities under the Dodd–Frank Act that will require a heightened focus on technology investments, data management, and analysis. We cannot continue to use yesterday's solutions for today's problems. We can't continue to ignore the fact that the markets we regulate are no longer dominated by traders who take orders over landline telephones and stand in crowded pits yelling out bids and offers that only the initiated can understand. I don't need to tell anyone from Chicago that those scenes are more part of our past than our present. Today, the futures and swaps markets are by and large electronic markets, heavily dependent upon advanced technologies. It's time that the CFTC adapts to that reality.

If we are to establish a credible surveillance and oversight program of both the futures and swaps markets, the CFTC needs to move past its antiquated ways of doing business. I am repeatedly struck by the lack of technological capacity at the agency. Our forms and filings are not required to be filed electronically, and those that are filed electronically do not automatically populate our trade surveillance databases. We have only a few automated surveillance alerts. None of those monitor real-time trading. While we rely on each designated contract market (DCM) to police its own trading to a certain degree, we have long recognized the interconnectedness of the market as a whole but have done little to address that reality.

Anniversary of the Flash Crash

May 6, 2011, was the first anniversary of the Flash Crash, an event that "highlighted the interconnectedness of the equities and derivatives markets."²² In minutes the markets dropped an unprecedented \$1 trillion. Thankfully, the market recovered, but not before it gave us a terrible example of how badly things can go when we don't have the right safeguards in place.

On February 18, 2011, over nine months after the Flash Crash, a joint CFTC–SEC advisory committee released a report that contained 14 recommendations. Both commissions will seek to integrate most of the recommendations into the Dodd–Frank rulemaking. They included putting circuit breakers or pauses in place; requiring DCMs to have strict supervisory requirements for firms implementing algorithmic trading; reporting measures; and establishing pre-trade risk safeguards. The Technology Advisory Committee (TAC), which I chair at the CFTC, formed a subcommittee to also look at safeguards and pre-trade practices for firms that engage in direct market access. The subcommittee came up with several pre-trade risk-management measures—which included pre-trade quantity limits on individual orders and price collars; execution and message throttles; a kill button on existing orders; clear error trade and order cancellation policies at the exchange level; and trading functionalities that operate within parameters set by clearing firms.

But the joint CFTC–SEC advisory committee noted that since May 6, 2010, there have been at least three other "crashes" related to algorithmic trading, which I believe have shaken market confidence and will undermine the important role both the equities and futures markets play. The CFTC can't possibly review each and every algorithm and certify its performance—that would be impossible. Instead, we are hoping to establish rigorous standards by which all firms must comply if they are going to utilize algorithms in their trading strategies.

CFTC's own technological divide

As market participants make investments in their technological capabilities to keep up with the ever-improving speed of business, the CFTC must also make critical investments in our own capabilities. For the past year, I have requested the CFTC be reorganized to create an Office of Data Collection and Analysis. This office should focus on securing and managing all of the CFTC's trade and surveillance data, working with all other divisions to monitor the futures and swaps markets and performing broad risk analysis for the CFTC. This office can drive the automation of cross-market surveillance programs, including the development of our own algorithms, enabling the CFTC to keep pace with new computer-generated trading styles as well as nefarious activities. Using the additional resources provided by Congress, we should attack our highest-priority technological challenges, such as automating our surveillance and integrating the swaps market data with futures market data.

Technology Advisory Committee

Finally, if we are going to keep pace with the market's appetite for new technological capabilities, we have got to keep a dialogue going with market participants about where the market is headed. I mentioned the work of the TAC to help identify possible safeguards in response to the Flash Crash of May 6, 2010. I recently established another TAC subcommittee to focus on developing standardized reference data for the universe of legal and financial terms used to describe, define, and value various derivatives and other financial instruments. The creation of standardized reference points and data terms will aid in the development of universal entity, product, and/or instrument identifiers and provide greater consistency in the collection, reporting, and management of individual transactions.

Sound and fury signifying nothing?

It's easy to focus on how much is changing because of the Dodd–Frank Act. The CFTC and the other federal financial regulators are writing rules at a frenetic pace, and the market is already positioning itself to deal with the changes to come. There's no doubt that much is changing and that a lot of good will come of this. Earlier I quoted Winston Churchill, so let me close with some more of his good advice: "However beautiful the strategy, you should occasionally look at the results."

As such, I find myself asking if we are really going to change the fundamentals of the market. If we take the flexibility out of the swaps market by trying to make those unique instruments trade as though they're futures and if we ignore the characteristics that make swaps

useful tools to hedge risk, aren't we sacrificing market innovation for the lazy comfort of sticking to what is more familiar?

From the way the draft rules seem to be shaping up, I would argue that the dealers will remain in a key market-making role, though it will be a more expensive responsibility. Do we want a market that leaves dealers as the prime marketmakers in the swaps arena, which would result in less competition, not more? Much of this will depend on whether or not we can move to more-standard products and reduce the customization of these products.

While I didn't mention it before, I am interested to know what others think the impacts of establishing two different margining regimes for futures and swaps will be. Will there be any opportunities to better manage risk in the futures and swaps markets? Or might capital flee into fewer but more-esoteric, bespoke products traded in dark over-the-counter markets that can't be cleared?

And finally, a question for all of us to consider: If we have perpetuated concentrations of risk and harmed competition, have we really fixed the nemesis that is "too big to fail"? If we haven't, I'm afraid that at the end of the day, we may have created a good deal of sound and fury that for the American people will signify nothing.

I'm looking forward to the ongoing discussions on these issues and to doing some of that listening that I have been counseled I should do. I know that if we are going to find answers to any of these questions, it will be because we were thoughtful and took into consideration the views of the entire market.

NOTES

¹Working definitions of these products and related terms are available at www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_s.

²Joint CFTC–SEC Advisory Committee on Emerging Regulatory Issues, 2011, "Recommendations regarding regulatory responses to the market events of May 6, 2010," report, Washington, DC, February 18, available at www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/jacreport_021811.pdf.