American Cotton Shippers Association
88 Union Avenue, Suite 1204
Memphis, TN 38103
United States

P +1 901 525-2272
F +1 901 527-8303
www.acsa-cotton.org

CFTC GMAC Meeting

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Provided by:

OVERVIEW

For questions on the note below, please contact Daniel Austin or Edmund Perry at 202-547-3035.

Today, the U.S. Commodity Futures Trading Commission (CFTC or Commission) held a meeting of its Global Markets Advisory Committee (GMAC or Committee) to hear presentations and provide dialogue on U.S. Treasury market issues. Conversations focused on recent stresses in markets and market reforms to prevent future stresses.

Key Takeaways

• FIA PTG Executive Committee Member Graham Harper from DRW said that central clearing would improve Treasury market resiliency, transparency, and liquidity, but there are market structure issues that must be resolved before a clearing mandate would even be possible. The most significant impediment to clearing currently is that clearing members are permitted to accept only transactions that are executed with them, meaning that participants are unable to locate clearing members to clear entire portfolios. Harper said that FIA PTG recommends that FICC remove sponsored members' ability to discriminate based on execution counterparty and require clearing members to operate independently from affiliated trading businesses when deciding whether to offer clearing.

• FICC General Manager Laura Klimpel said she agreed that there should be a viable client clearing models for market participants that cannot or choose not to become direct members of FICC but said that FICC already offers various options for clearing for market participants. She said that a singular model for clearing would disenfranchise many market participants, such as money market funds. She also said that concerns that intermediaries are reluctant to provide agency clearing services are unwarranted, and

FCMs have expressed enthusiasm about this prospect. Klimpel noted the importance of improving the efficiency of cross margining between cash and derivatives and said that FICC will be releasing proposals to improve cross margining by June 2022.

• Stanford University Professor Darrell Duffie said that central clearing and all-to-all trading would lower dealer commitments and free up balance sheets in a way that could have alleviated the market stresses seen in March 2020 Treasury markets. Duffie noted that dealer balance sheets have become increasingly constrained since the 2008 financial crisis, and this has become unsustainable as Treasury markets have continued to expand. He said that well-regulated central clearing would also reduce counterparty risk and settlement failures and make markets more transparent. He also noted that the FIA PTG white paper provided insight on how to introduce central clearing more appropriately without the need of a strict regulatory mandate.

• Commissioner Dawn Stump said that Treasury markets are interconnected with derivatives markets, making it important for the CFTC to study these issues, but she noted that reform to Treasury markets will involve other regulators more directly.

• After discussions of Treasury markets, there was also a presentation on the implementation of Dodd-Frank reporting requirements. Tara Kruse, International Swaps and Derivatives Association (ISDA), recommended the use of a mutualized regulatory code for collecting transaction data. She said this would allow for a standardized model that would ensure data-driven rules, direct operational output, eliminate reconciliation issues by promoting a single interpretation of regulations, and enable interoperable solutions to regulatory concerns. Colin Lloyd, Cleary Gottlieb Steen & Hamilton LLP, noted that there are cross border implications of new swap data reporting requirements that have been alleviated through no-action relief and exemptions, but these arrangements will end in roughly a year, so the CFTC needs to consider how to address foreign privacy laws that may cause issues with reporting requirements.

SUMMARY

Opening Statements

Commissioner Dawn Stump (GMAC Sponsor)

Healthy Treasury markets are vital to having strong derivatives markets, so these issues are of importance to the CFTC. We should focus our discussions on recent market stresses and find an understanding of how we could mitigate these issues in the future.

We cannot ignore the impact of post-financial crisis reforms on liquidity providers. I recognize that some of the potential paths forward involve other regulators, but the impact on derivatives markets makes it necessary for the CFTC to engage on these issues. We must be willing to look at issues dynamically and update our rules.

Acting Chairman Rostin Behnam

This is one of the most pertinent conversations possible in assessing current risks to markets. I am interested in studying the relationship between cash Treasuries and derivatives more thoroughly.

Panel 1: Treasury Market Structure and Recent Events

Sam Schulhofer-Wohl, Senior Vice President and Director of Financial Policy and Outreach, Federal Reserve Bank of Chicago

There have been significant dislocations in the Treasury market in recent years, such as recent repo disruptions and the disruptions at the start of the pandemic. Overall, there were several distinct sources of volatility during the pandemic. Many Americans sold their Treasury holdings for cash. Some market participants were motivated to unwind positions when the market became too volatile. Cautionary concerns amplified the initial sales, such as concerns that markets would become unviable. The result of these activities was that there was not a sufficient supply of liquidity in Treasury markets to meet market participant demand. The 2019 repo volatility spilled over into other markets. Even though the dynamics of this event were different from the pandemic volatility, they are similar in that supply of liquidity could not meet demand.

There have been calls to increase dissemination of market data for the public, and more data transparency could benefit all market participants. There have been calls for more central clearing in Treasury markets. Central clearing improves risk management. Central clearing concentrates risk at the central counterparty. The SEC has considered extending Reg ATS to Treasury ATSs.

Michael Pedroni, Executive Vice President and Managing Director, Head of Global Research and Markets, Managed Funds Association (MFA)

There are several Treasury market attributes that we should keep in mind when considering any reforms. Treasuries are not a uniform market, and each type of treasury trades differently. Surprise shock from COVID prompted heavy redemptions and an overseas dash for dollars. Treasury markets rely on multiple participants, not just traditional dealers, for liquidity. Repo Treasuries rely heavily on bilateral relationships.

During the dash for dollars in March 2020, the sellers were from non-U.S. accounts (34 percent), foreign private accounts (29 percent), mutual funds (31 percent), and hedge funds (6 percent). Foreign central banks selling was a major source of turmoil during the pandemic.

The early narrative of the pandemic volatility was that hedge fund basis sellers were engaged in fire sales which caused the volatility, but the evidence of this is weak. Hedge

fund basis traders were actually supporting the liquidity in these markets. Hedge funds hold about 15 percent of their investing assets in cash as a precaution in case of volatile times like this.

Jennifer Han, Chief Counsel and Head of Regulatory Affairs, Managed Funds Association (MFA)

We believe that cash markets would benefit from more central clearing. Roughly two-thirds of Treasury repo transactions go uncleared. Regulators should work to expand voluntary central clearing solutions before considering a clearing mandate. This will benefit investors by allowing them to net offsetting transactions.

We should also make targeted enhancements to regulatory data collection and improve data dissemination. We should carefully introduce public dissemination of post-trade transaction data. Public price reporting will improve markets to be consistent with the transparency in other markets. We should also rationalize trading venue oversight. We believe that SEC Reg ATS should be expanded to Treasury markets. We also recommend that the SEC examine multilateral RFQ venues.

Q & A

Stump: In the event that clearing became more prominent in this space, should there be considerations of changing the types of collateral that would be eligible? *Supurna VedBrat, BlackRock:* Yes. We are in favor of central clearing due to how it improves market resiliency. From a collateral standpoint, I would like us to consider an expansion of acceptable collateral and enhance the ability for clients to be able to net collateral posted. We want very liquid assets for collateral, beyond what is already accepted, such as various liquid ETFs or money market funds.

VedBrat: When we are talking about clearing solutions, are we talking about both on the run and off the run? *Pedroni:* The market would benefit from central clearing of off the run Treasuries. That is an area where clearing solutions are very limited at the moment.

Masahiro Yamada, JP Morgan Securities LLC: Should the holders of on the run and off the run treasuries be consulted when discussing disseminating their trade data? *Pedroni:* The idea is to disseminate aggregate anonymized information, so users of that data would have access to price and quantity, but not to who conducted a trade; *Han:* We advocate for a careful and qualified approach to disseminating data.

Panel 2: Clearing in the Treasury Market

Professor Darrell Duffie, Adams Distinguished Professor of Management and Professor of Finance, Graduate School of Business, Stanford University

Bid-offer spreads widened dramatically after March 2020, leading many market participants to struggle to obtain liquidity. It is believed that the Fed could come in and fix this situation, but it took several weeks, despite Fed actions, before bid-offer spreads returned to normal.

Central clearing has several benefits, including lowering the commitments of dealers and freeing up their balance sheets. All-to-all trades would also lower these commitments. Dealer balance sheets have been much more constrained since the financial crisis, but Treasury markets have expanded greatly, so this is unsustainable.

Well-regulated, market-wide central clearing reduces settlement commitments dramatically and would lower counterparty risk and make markets more transparent. Central clearing also reduces settlement failures by clearing dealer balance sheets. The question is how to get better central clearing. The FIA PTG paper provides a lot of clues on how to appropriately introduce better central clearing without a heavy regulatory mandate. Hopefully, FICC can show us where the roadblocks are for this process.

Graham Harper, FIA Principal Traders Group Executive Committee Member and Head of Public Policy and Market Structure, DRW Trading Group

There are many issues that need to be resolved before any clearing mandate could be possible. We believe that central clearing improves market resiliency, market liquidity, and market transparency, and we have always advocated for the value of increased central clearing. Most Treasury transactions are uncleared. Achieving more central clearing requires implementing an effective client clearing model at FICC.

Irrespective of asset class, most market participants access clearing through a client clearing model. In sponsored clearing, clearing members are allowed by FICC to elect to only accept transactions that are executed with them. This means market participants are unable to locate a clearing member to clear their entire portfolio across execution counterparties.

We recommend that FICC implement enhancements to its client clearing offering so that it is available to all market participants by removing the ability of sponsored members to discriminate based on execution counterparty and by requiring clearing members to operate independently from affiliated trading businesses when deciding whether to offer clearing services. FICC should allow direct clearing members and clients to utilize cross margining arrangements on fair terms and should ensure clients are adequately represented in CCP governance processes.

Laura Klimpel, General Manager, Fixed Income Clearing Corporation

FICC agrees that Treasury markets require viable client clearing models for market participants that cannot or choose not to become direct members. That said, the FIA PTG presentation mischaracterized our models. We have various options for central clearing to

account for the diverse array of market participants in Treasury markets. FICC's correspondent clearing model does not require clients to become a member of FICC and allows FICC to net the margin associated with their activity, which results in a reduction of market costs, which is valuable to clients. The FIA PTG presentation noted that minimal repo transactions are flowing to the corresponding brokerage clearing models. Most of this activity is cash Treasury activity. The accounting analysis necessary to be a clearing agent is something that most dealers are unwilling to do.

FIA PTG notes that FICC does allow sponsoring members or third parties to execute clearing. FICC believes that this is essential to our obligations to retain all the client clearing models we currently have. A singular model for clearing would not work and would disenfranchise many market participants. Money market funds are critical liquidity providers in Treasury markets but are not capable of participating in a FCM model. To avoid disenfranchising these groups, it is essential to have client clearing models such that clients can pay a spread. The counter concern articulated by the FIA PTG white paper is that intermediaries are reluctant to provide agency clearing services, but FICC has reached out to FCMs about this and was met by enthusiasm for this concept by these firms. That said, there is more work to do to ensure the viability of client clearing at FICC, especially with the possibility of a clearing mandate.

We need to improve the efficiency of cross margining between cash and derivatives. Current cross margining arrangements are being worked on to improve efficiency, and we hope to release proposals by June 2022. Cross margining arrangements covering positions held by customers have never been approved. Another area where public-private partnerships are required is the treatment of margins posted by a client. Unlike in the derivative space, a clearing intermediary at FICC is not allowed to rehypothecate margin. This requires intermediaries to use their own funds to cover margins which makes this very challenging.

Q & A

Sunil Cutinho, CME Clearing: Cross margining is very important, but it is limited to direct members. The ideal program would be the one used in the Options Clearing Corporation.

Amy Hong, Goldman Sachs: Central clearing can deliver important benefits to clients, but I do not believe it would not have relieved the supply imbalance that caused volatility in March 2020. Would central clearing have reduced market stress, particularly in off the run activities? *Duffie:* Dealer balance sheets were the scarce resource in 2020. Dealers had clogged up balance sheets, so they did not want to take more trades except at a large bid-offer spread. Central clearing would have reduced settlement failures and freed up balance sheets dramatically; *Klimpel:* Central clearing cannot alleviate all dealer balance sheet issues. But, when there is a supply demand mismatch, central clearing protects the system from market participant defaults.

Joseph Nicosia, Louis Dreyfus Company: Has FICC analyzed the capital levels that would be necessary for increased clearing to be offered? *Klimpel:* The model that FICC uses to charge for margin and liquidity resources is heavily scrutinized by regulators, so there is always analysis of necessary capital levels. In addition to that, FICC is a utility, so we are aligned with our owners in the sense that our owners are members of the CCP. We believe that the resources we provide allow us to absorb the cost of increasing Treasury clearing.

Supurna VedBrat, BlackRock: When a trade goes to FICC, do the original counterparties have residual risk to one another, especially in the event of a default? *Klimpel:* When we are talking about sponsored clearing, funds become direct limited members of FICC. So, when that happens, FICC will become the obligor to the fund on that transaction such that, if there is a default, FICC is obligated to perform for the fund under the CCP guarantee. If there is still a relationship to the intermediary, the clearing intermediary must act as the processing agent, and they retain a responsibility to FICC to be a guarantor of the fund's performance to FICC.

VedBrat: We cannot have electronic trading without central clearing. Market access allows you to choose who your counterparty is, so linking execution of trading with large scale clearing is important.

Duffie: I have a question about the FIA paper's suggestion that it is problematic when a clearing member is also the dealer. What would prevent a PTG from clearing through a FICC member to avoid the conflict of interest? There are fees lying in the way of clearing currently, but there is a need for this to happen to protect all market participants. *Harper:* There are not sponsors offering the services PTGs are looking for. Most people need a portfolio approach to clearing, so not all trades will have been executed by the clearing member. The rulebook does allow for this, but it is just not available commercially; Klimpel*:* Most likely, it would be better to have intermediaries with agency clearing models to translate into the cash Treasuries clearing space. I would argue that this issue has not come to a crescendo until now, because agency type activity happens outside of central clearing because there is no clearing mandate. As participants try to bring more activity into central clearing, this issue comes to a head and must be addressed. From FICC's perspective, it will not be in every agency business model to provide clearing services. Central clearing has historically enabled all-to-all brokers. IDB trading comes through the CCP because participants in that market are all members or clients of a FICC member.