As Prepared for Delivery

Thank you, Philip, for that warm introduction.¹ It’s good to be here at FTF DerivOp’s 2016 Conference. I’m glad to see so many of you gathered here who are involved in derivatives operations, the often underappreciated nuts and bolts of what truly makes the derivatives industry function. It is an honor to deliver these remarks to wrap up the first day of this conference. And I am very aware that I am the only thing standing between all of you and cocktails, hors d’oeuvres and networking at the welcome reception. So, that concludes my remarks . . .

It’s a pleasure to be back in Chicago, which is home to some of the largest exchanges and clearinghouses in our industry. I am also pleased that this conference was scheduled to coincide with the Cubs home opener. . . . It is spring, a time of hope, the “next year” we have been waiting for, the time when all our teams are in or near first place.

I must add the disclaimer that the views I am expressing today are my own, and not necessarily those of the Commissioners or staff of the CFTC.

So today, I would like to talk about some recent developments and current priorities. I will touch briefly on how we are dealing with emerging threats and opportunities. And I would also like to talk with you about how we hope to use

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swaps data in the Division of Clearing and Risk (DCR) to accomplish our mission better. Last, time permitting, I will turn to the work we are doing to oversee the launch of swaptions clearing that occurred in Chicago today.

**Common Approach for Transatlantic CCPs**

I would like to start by noting the historic and significant agreement that the European Commission and the CFTC reached in February. This accord sets forth a common approach regarding requirements for central counterparties, or CCPs, and is significant in several ways.

First, it resolves the issues that were standing in the way of Europe “recognizing” U.S. CCPs. And it thereby helps make sure that the U.S. and European derivatives markets can continue to be dynamic, with robust competition and liquidity across borders.

Second, the agreement is an important step in achieving cross-border harmonization of derivatives regulation. This is particularly significant as the European clearing mandate for swaps approaches this June. This in turn reflects the progress we have made in increasing the use of central clearing. Strong cooperation among regulators in the oversight of major clearinghouses is the right way forward, and this agreement provides a foundation for that.

Just a few weeks ago, the CFTC held up its end of the deal by unanimously approving a “substituted compliance” order. This framework permits European CCPs to comply with many of our rules by meeting comparable European requirements. That further harmonizes our regimes, and will streamline the registration process for European CCPs that wish to clear for US customers. At the same time, DCR issued limited no-action relief to EU CCPs from the application of certain of our regulations to discrete aspects of their non-U.S. clearing activities.

We and our CCPs are actively working with the European Securities and Markets Authority (ESMA) to submit any additional information that is required to complete their applications for recognition as well. Completing the recognition process in a timely manner will ensure that that the global derivatives market can continue to function smoothly and efficiently.
Clearinghouse Resiliency

Another major area of focus for us this year is clearinghouse resiliency. On the international front, there are several important workstreams under the auspices of CPMI-IOSCO -- the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO). These are looking at a number of issues pertaining to clearinghouse strength and stability. The CFTC is co-chairing this effort. This work includes looking at margin methodologies and the resources available to a clearinghouse in the event of a default, such as “skin in the game” and “cover one” versus “cover two” standards. It includes looking at standards for stress tests. It is also looking at standards for CCPs’ liquidity arrangements and CCP governance. This group is also examining whether further granularity or guidance is needed with respect to the Principles for Financial Market Infrastructures (PFMIs) across these areas.

We are also actively working on recovery and resolution planning – at the adequacy of resources and procedures in the event of a major problem. We are working with the major clearinghouses to review their recovery plans. That includes exploring auction procedures to increase efficiency and participation; considering under what circumstances, and to what extent, gains-based haircutting is an appropriate tool to allocate losses. This also includes examining tools, such as partial tear-ups, that may be used to re-establish a matched book; and discussing the governance mechanisms over the use of recovery tools. We are also looking at transparency around the potential use of those tools.

We are involved in additional efforts led by the Financial Stability Board to examine resolution planning for clearinghouses, including international coordination. Another group is examining the interdependencies among global clearinghouses and major clearing members.

We are also working directly with our fellow domestic regulators on this type of crisis planning. To that end, last month my team hosted a half-day tabletop exercise with staff from the FDIC, Federal Reserve Board and US Treasury to explore how U.S. regulators would potentially respond if a clearinghouse faced credit or liquidity shortfalls as the result of the defaults of multiple participants.
While we must engage in recovery and resolution planning, our goal is never to get to a situation where either of those is necessary. And that is why risk management is so important. Sometimes in the current discussions about clearinghouse resiliency, the activities that comprise ongoing risk management don’t get much attention. But those activities—the daily margining practices, the stress and back testing, the oversight and ongoing risk surveillance and relevant examinations—are critically important. These everyday activities as just as important, if not more so, than recovery and resolution planning and implementation.

Of course, we are a regulator and our role is one of oversight. The clearinghouses themselves have the front line responsibility here—and it is their practices that are most critical to risk management.

**Emerging Threats and Emerging Opportunities**

Let me now turn to cybersecurity. Cyberattacks may be the greatest threat facing our financial system today. The Commissioner recently proposed a new rule regarding cybersecurity for CCPs.

Our proposal is simple: CCPs should follow industry standards and best practices when it comes to testing their defenses and other protections against similar technological risks. At appropriate intervals, this may involve assistance from independent experts in some respects. DCR staff are currently reviewing the comments we received to the rule proposal. I hope DCR can prepare a final CCP cybersecurity rule for adoption by the Commission by this summer.

The proposed rule, approved unanimously by the Commission, shows that we are not just looking back, as we must, to address the causes of past crises. It shows that we are also looking ahead, and taking action to address future threats to financial stability. We will continue to make cybersecurity a priority in our examinations. We will continue to work with other agencies to enhance intra-governmental cooperation, and cooperation between government and industry, so that we share information about cyber threats—and plans for responses.
And let me also mention another recent event that indicates how the Commission is looking ahead. At a recent meeting of the CFTC’s Technology Advisory Committee, our agenda included a discussion about the potential application of blockchain technology, also referred to as distributed ledger technology (DLT). We recognize that DLT could be very important in future years, and we will continue to look at it. Commission staff are actively monitoring developments and new initiatives as well as meeting with various technology firms and market participants involved in distributed ledger technology.

**Data**

Data is one of the most significant accomplishments of the Dodd-Frank Act, so I would like to spend most of my remaining time talking about this subject. I am sure that many of us in this room are familiar with not only the power of data, but its complexities and challenges.

I’d like to discuss how the Division of Clearing and Risk is using SDR data today, and how we plan – as data quality and completeness improves - to use it in our Risk Surveillance program in the future. And I’d also like to explain to you in a bit of detail the nature of the efforts we are making to improve the quality of the swaps data we receive.

**CCP Oversight**

In DCR, we go about our oversight of clearinghouses in a number of important ways. We achieve this through our statutory framework for clearinghouses, our rules and regulations, our policies, and our supervisory program. We regularly perform examinations of clearinghouses for compliance with 18 core principles. We engage in rule and product review, and review of risk and margin models. And of course before a CCP is permitted to clear trades for US participants, it must complete a rigorous registration process.

**Risk Surveillance**

First, a word about our risk surveillance program for CCPs.
Commission risk surveillance staff monitor CCP risks at multiple levels. The key types of risks include market risk, liquidity risk, credit risk, and concentration risk.

We look at the risks posed by CCPs,
We look at risks posed to CCPs by clearing members and traders. We also look at risks posed to clearing members by traders.

Our risk surveillance program contains four fundamental components:
1) identifying traders, clearing members, and CCPs at risk,
2) estimating the magnitude of the risk,
3) comparing the risk to the available financial resources, and
4) assessing the risk management practices of the traders, clearing members, and CCPs.

A critical engine that drives this program is data. The data focus consists essentially of positions, financial resources, and pricing data.

On a daily basis, we receive:
• Daily firm positions by house or customer origin
• Daily large trader account level positions
We obtain this data from market participants, clearing members, and CCPs. We also obtain daily information about initial margin held, variation margin paid and received, and other financial information, primarily from CCPs. And we obtain pricing information from independent market sources and from CCPs.

DCR’s risk surveillance program focused initially on cleared futures. Next, we added cleared swaps, and have been working to integrate cleared futures with cleared swaps. What I would like to talk to you about now is how we are expanding the program to cover uncleared swaps.

Data from the SDRs is the principal source of uncleared swaps data.

As we and other parts of the Commission have sought to increase our use of SDR data, we have discovered that significant changes are required to make SDR data complete, consistent and of reliably high quality for our use. This has led to the Commission issuing a proposed rule regarding swap data reporting and recordkeeping for cleared swaps\(^2\), which I hope will be made final soon. It also

led to CFTC staff’s “Request for Comment” (RFC) on draft technical specifications for certain swap data elements, issued this past December. I will also refer to the RFC as the “Consultation Paper”. I’m sure that many of you and your firms have reviewed, and perhaps commented, on one or both of these.

What DCR wants SDR data for

DCR relies on SDR data for uncleared positions and transaction data. Because our focus is risk, DCR is primarily interested in position data, not transaction data but DCR needs transaction data to be clear and complete so we are confident that positions can be represented accurately. Any analysis can only be as good as the quality of the data it is based on. [SEE SLIDE ATTACHED AS APPENDIX A]

Working backwards from that objective – having accurate information about positions – requires us to identify open swaps. We need to make sure that we are seeing the correct and most up to date attributes of each open swap. Doing this will rely on what our analysts call an “event model”. An “event” describes what parties did in the market place to move risk or transform how it is represented. Trades, amendments, early terminations, novations and compressions are examples of events. The event model is a method to transform messages into the events that analysts care about. Even a simple event like a new trade can be represented by multiple messages that initiate, update, change, correct and sometimes cancel the trade. Seeing through these events lets us calculate which swaps are currently open and should be included in risk calculations.

So from messages are built events. From events we distinguish the open swaps. And from the open swaps, one can then represent the positions held by market participants. From there, the things we can do in furtherance of our mission get much more interesting.

3 http://www.cftc.gov/PressRoom/PressReleases/pr7298-15
DCR is working on building a comprehensive valuation program for uncleared swaps. The ability to independently value a swap based on SDR data is critical. The ability to perform valuations is also critical in providing a foundation for us to run stress tests – as we do for cleared futures and swaps – to understand the risks a market participant might face. We want to see those risks not just under today’s conditions, but under other potential scenarios as well – for example if interest rates jump, or the shape of the curve changes. This also lets us see the impact on other market participants who have exposure to that participant.

And in the next phase, we would also like to be able to understand those risks in the context of the margin or collateral held against those positions. We are able to do this in our surveillance program for cleared swaps and futures. For uncleared swaps, we would like to understand not just the exposures but the uncollateralized exposures – that is, the obligations considering the collateral posted. This requires the ability to identify netting sets, the value of swaps in those netting sets, and the collateral posted to those netting sets. This is one of the principal areas where the RFC identifies new fields, and greater clarity of existing fields. To achieve these goals, improved reporting is vital.

The Work that produced the December 2015 Consultation Paper

Now that I’ve explained what we want the data for, I’d like to talk with you about the work people at the Commission did that led to the Request for Comment. Staff across the Commission started by reviewing all the fields being reported to SDRs. Staff subject matter experts identified those data elements, existing or new, which were of highest priority in achieving their respective missions and duties. They focused on the use cases that they needed SDR data for. The highest priority use cases were identified, and SDR data fields were then mapped against the use cases. The goal was to confirm the highest priority use cases against the highest priority data fields, and to confirm which data elements supported these use cases and which elements were missing.

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4 i.e. which swaps are being netted against one another
The next step was to determine both the meaning of those priority data fields and what the allowable values should be. At this phase, Commission staff where possible sought to apply international standards, such as those being developed under the CPMI IOSCO Swap Data Harmonization Group including the Unique Transaction Identifier (UTI) and Unique Product Identifier (UPI) processes that the CFTC is helping to lead. They sought to leverage industry standards, where available, as well.

The next step was to establish a “war room” of dedicated subject matter experts from across the agency, as well as external resources provided by the Office of Financial Research, whose help we greatly appreciate. They were charged with setting priorities and focusing on the data elements that would net the largest improvements in the CFTC’s capabilities in these priority fields and use cases, by standardizing existing fields or adding new ones. The subject matter experts deployed to the war room were among the heaviest users in the Commission of SDR data. These “power users” – what in the industry you would call the front office users of the data – have had hands-on experience using the existing SDR data to produce deliverables for their divisions. These included not just lawyers, but economists, risk analysts and other quants.

The power user experts drove the priorities, and they drove the assessment. The result is that the suggestions in the Consultation Paper originate from people most familiar with how the data has been used and will be used.

The war room was just an intermediate step, though. The industry’s feedback is very important, and Commission staff are in the process of reviewing the many constructive comments that were received.

**Swaptions Clearing**

Today also marks the announced launch of CME’s service of clearing IRS swaptions. I would note that this clearing service is offered on a voluntary basis; the CFTC has not mandated clearing of swaptions.
I would like to say a few last words about our oversight of this swaptions service launch.

First, under our rules, a CCP launching a new product that introduces material new risks must submit the product for our review well in advance of its launch. In this case, because CME has been deemed “systemically important”, we reviewed their application submission in consultation with the Federal Reserve Board for an extensive period before advising CME in early 2015 that we did not object to its plans to clear swaptions.

Second, while I am about to discuss DCR risk surveillance oversight of swaptions clearing, it is the CCP that has primary responsibility for safe risk management and default management of its products.

As is the case with any product containing optionality, swaptions pose certain non-linear risks. Our Risk Surveillance Branch (RSB) has extensive experience dealing with options on futures. Conceptually, swaptions raise the same types of issues as options on futures. A major difference is that the greater number of variables involved in computing the value of a swaption increases the complexity of the analysis.

I. Reporting

We have been working with CME to ensure that adequate data is available for our oversight of swaptions clearing. Specifically, we have been reviewing samples of the following swaption reports which will be submitted daily from the date of the launch: (i) a trade register (open swap report); (ii) a margin report; (iii) delta, gamma, and vega ladders; and (iv) a volatility surface report.

II. Daily Risk Surveillance

We expect that from today’s outset and onwards, we will be able to:

i) identify the specific house and customer accounts with swaption positions;

ii) calculate margin for portfolios that contain swaptions; and
iii) conduct stress tests of those portfolios.

We will also use the delta, gamma, and vega ladder reports to enhance its current IRS stress testing capabilities. On a parallel track, our risk surveillance team is developing the ability to conduct full revaluation of portfolios containing swaptions. This is very computationally intensive because of the number of variables that must be measured and the number of calculations that must be completed. But it will be useful to have this capability because it provides a means of capturing more precisely the non-linear risks of swaptions. As is its typical practice, our risk surveillance team plans to compare its results with those generated by the CCP.

This work will allow our risk surveillance to include cleared swaptions in its daily risk analysis and potentially to include uncleared swaptions as well. Experience with cleared swaptions will have the additional benefit of assisting our understanding of uncleared swaptions in the development of our overall uncleared swap risk surveillance program.

Conclusion

So as you can see, like yourselves, we have a busy year ahead of us.

Thank you again for inviting me here today. I’d be pleased to take a few of your questions.

Biographical Note

Jeffrey M. Bandman is Acting Director, Division of Clearing and Risk, U.S. Commodity Futures Trading Commission. He also chairs a CFTC interdivisional staff working group on blockchain and virtual currency issues. He originally joined the Commission as Special Counsel to the Chairman, Office of the Chairman, in 2014 and also served as Acting Director, Office of International Affairs, in 2015.
Previously, he worked for many years in the derivatives industry. He advised the Futures Industry Association on launching the SEF Tracker in 2014. As Head of Partnerships and Alliances for LCH.Clearnet Ltd.’s SwapClear service, he was responsible for global arrangements with execution venues, technology providers, trade repositories, custodians, consultancies and others in the OTC ecosystem. He spearheaded the launch of SwapClear’s innovative CCP\(^2\) partnership program for OTC clearing consultancies and led development of the award-winning SMART margin simulator. He served with colleagues and industry on the Design Authority for the SwapClear FCM service.

He is the author of *Cyber Risks in Exchanges and Clearinghouses – A Regulator’s Perspective* in the September 2015 Eurofi magazine. He is also the author of *Swaps Transparency - New Data from SEF Trading*, the cover story of June 2014 Futures Industry, and *The New Clearing Landscape in the U.S., U.K. and Europe* in the November 2010 issue of *Journal of Taxation and Regulation of Financial Institutions*.

Mr. Bandman earlier worked on a variety of new market structure initiatives in the derivatives industry in New York and London, including LiquidityHub and the Project Rainbow consortium. Before that he rebuilt and managed Cantor Fitzgerald’s market data business after the events of September 11. Mr. Bandman started his career as a corporate associate at Cravath, Swaine & Moore in New York and then served as Americas General Counsel for Prebon Yamane and Prebon Energy. His undergraduate degree is a B.A. with honors in both History and English from Yale, and he has a law degree from Stanford. He is admitted to the New York and New Jersey bars.