

FIA Global Launches CCP Rulebook Review

FIA Global announced a new service that will provide information on clearinghouse rules worldwide and help market participants assess the risks of clearing.

The FIA Global CCP Rulebook Review will provide a standardized, comprehensive overview and analysis of clearinghouse rules and procedures as well as timely updates on changes to the rules and regulatory framework. Two law firms—Linklaters LLP and Milbank, Tweed, Hadley and McCloy—have been engaged by FIA to support the service.

“As global regulators implement centralized clearing requirements, there is an increased focus on monitoring the risks associated with clearing derivatives products,” said FIA President and Chief Executive Officer Walt Lukken. “The FIA Global CCP Rulebook Review will provide a comprehensive map to this new terrain.”

U.K. Extends Libor Rules to Gold Fix, Brent Futures and Five Other Benchmarks

On Sept. 25 the U.K. government launched a consultation on extending the regulatory framework put in place for Libor to cover an additional seven benchmarks in the foreign exchange, fixed income and commodity markets.

The seven benchmarks under review are:

- The Brent crude oil futures contract traded on ICE Futures Europe
- Two interest rate benchmarks, Sterling Overnight Index Average (SONIA) and the Repurchase Overnight Index Average (RONIA), which serve as reference rates for overnight index swaps
- WM/Reuters 4pm London Fix, which is the dominant global foreign exchange benchmark
- ISDAFix, which is the principal global benchmark for swap rates and spreads for interest rate swap transactions
- Two precious metals benchmarks, the London Gold Fixing and the LMBA Silver Price.

The government said it expects to have the new regime for the designated benchmarks in place by the end of this year. This will mean new requirements, including anti-manipulation rules, for the companies

that administer these benchmarks as well as the companies that provide information to the administrators.

ESMA Finalizes Clearing Requirement for IRS

On Oct. 1, the European Securities and Markets Authority issued final draft regulatory technical standards for the clearing of interest rate swaps, setting in motion the implementation of mandatory clearing in Europe.

The RTS define the types of interest rate swaps that will have to be cleared, the types of counterparties covered by the obligation, and the dates when clearing will become mandatory. The RTS have been submitted to the European Commission, which has up to three months to endorse the standards. Absent objection from the European Parliament and the European Council, the RTS is expected to come into force in February.

The clearing obligation will be implemented in four phases, depending on the type of firm:

- Category 1: Clearinghouse members – six months after the effective date
- Category 2: Financial counterparties and alternative investment funds with more than 8 billion euros in uncleared swaps – 12 months after the effective date

- Category 3: Financial counterparties and alternative investment funds with less than 8 billion euros in uncleared swaps – 18 months after the effective date

- Category 4: Non-financial institutions above the EMIR clearing threshold (NFC+) – 36 months after the effective date.

If a contract is entered by two counterparties in different categories, the clearing obligation applies at the later of the two dates. The clearing obligation will apply to basis swaps denominated in EUR, GBP, JPY, USD; fixed-to-float swaps denominated in EUR, GBP, JPY, USD; forward rate agreements denominated in EUR, GBP, USD; and overnight index swaps denominated in EUR, GBP, USD.

The RTS also include a frontloading obligation, which applies to interest rate swaps that are entered into after the publication of the RTS but before the RTS enter into effect. The frontloading obligation applies primarily to category 1 and 2 counterparties.

ESMA Consults on Clearing Requirement for FX NDFs

On Oct. 1, the European Securities and Markets Authority published a consultation on standards for the clearing of foreign exchange non-deliverable forwards. The proposed standards would require clearing for cash-settled NDFs in 11 currencies, with maturities of three days to two years. Once finalized, the clearing requirement would be implemented in four phases:

- Category 1: Clearinghouse members – six months after the effective date
- Category 2: Financial counterparties and alternative investment funds with more than 8 billion euros in uncleared swaps – 12 months after the effective date
- Category 3: Financial counterparties and alternative investment funds with less than 8 billion euros in uncleared swaps – 18 months after the effective date
- Category 4: Non-financial institutions above the EMIR clearing threshold (NFC+) – 33 months after the effective date

The proposal was triggered by the authorization of LCH.Clearnet in June. LCH.Clearnet currently offers clearing for these products. In addition, ICE Clear Europe, CME Clearing Europe and Nasdaq OMX have indicated that they plan to offer clearing for NDFs, according to the consultation paper.

In the U.S., the CFTC has not yet mandated clearing for any FX products, but CFTC officials said in October that they are developing a proposal covering 12 currency pairs with tenors ranging from three days to two years.

Pimco Calls for CCP Standards to Protect Client Assets

Pimco issued a white paper in October calling for global standards for clearinghouses to maximize the protection of client assets and reduce systemic risk. Pimco stressed that it supports the move to central clearing, but said it is concerned about the possible consequences if a central counterparty were to fail.

“Although failure is a low-probability event, Pimco nevertheless believes that certain global standards should be met by CCPs to maximize the safekeeping of clients’ assets, reduce systemic risk and ensure that the goals of the CCPs are aligned with protecting client assets,” the white paper said.

The white paper set out the following recommendations:

- CCPs should be required to have a minimum amount of “skin in the game,” i.e., a minimum amount of their own capital in the guarantee fund. Pimco recommended that this amount should be either \$20 million, or an amount equivalent to the third-largest clearing member contribution, or 5% of the total amount in the default fund, whichever is higher. Furthermore, this contribution should be fully funded rather than contingent in order to ensure that it is available during a time of systemic stress.
- If a clearing member fails, client assets

should only be accessed as a last resort after contributions from the CCP and the defaulting member have been fully exhausted. If client assets must be used, they should be used only through pro-rata haircutting of both initial and variation margin.

- Additionally, client assets should be afforded the same protections under the futures model as under the “legally separated, operationally commingled” model used in the U.S. for cleared swaps. The paper explained that in the case of a default, a clearinghouse cannot use the collateral posted for swaps transactions by non-defaulting clients to mitigate the losses due to the default. This is not the case for futures, however. “This bifurcation of market standards when it comes to segregation and protection of client assets under the futures and OTC models creates a system that is potentially less safe and more vulnerable to creating uncertainty and additional operational and legal risks for clients, clearing members, CCPs and regulators in the event that a clearing member or CCP were to fail,” Pimco said.
- CCPs should have the ability to deposit cash with central banks and enter into repurchase transactions with central banks in order to avoid the need to liquidate investments during a period of stress.
- CCPs should perform standardized stress tests periodically and the results should be reviewed and approved by regulators.
- Recovery of CCPs is better than resolution of CCPs because recovery allows markets to continue to function.

J.P. Morgan Calls for Resolution Plan in Case of Clearinghouse Failure

J.P. Morgan published a paper in September outlining a proposal to create a “resolution framework” to manage the unlikely event that a derivatives clearinghouse might fail. The paper states that the increasing size and required use of clearinghouses demand

“careful scrutiny” of whether the risk concentrated in clearinghouses represents “a new single point of failure” for the entire system.

The paper acknowledges that the proposed measures will probably increase the “upfront funding obligations” of many market participants, but argues that this is necessary to reduce the risk of market contagion and system destabilization. The paper recommends several measures in particular:

- A standard stress test framework should be mandated by regulators, with both scenarios and results disclosed to the public;
- All loss-absorbing resources should be pre-funded by removing reliance on unfunded commitments or assessments from members;
- Clearinghouses at the brink of failure should be recapitalized rather than liquidated so that they can continue to provide systemically important functions;
- Clearinghouses should have sufficient “recapitalization resources” so that they can open on the business day following a failure with a fully funded default fund. These resources should be provided by both the clearinghouse and its members;
- Clearinghouses should contribute a minimum amount to their guarantee funds and the recapitalization resources. This amount should be greater than either 10% of the guarantee fund or the largest single clearing member contribution;
- Beyond this minimum, clearinghouses should have the flexibility to determine how total resources are divided and allocated among members, end-users and the clearinghouse itself.

Brevan Howard Backs Research on Financial Crises

Brevan Howard, a U.K. based hedge fund, has provided £20 million in funding for a new research center in London that will seek to understand and prevent financial crises. The center, which will be housed at the Imperial College Business School, is

intended to serve as a bridge between academic economists and financial policymakers. The center will be led by Franklin Allen and Douglas Gale, two economists who specialize in research on financial institutions and financial markets.

“The Center’s scholars and research agenda will tackle the issues that have gripped me and my colleagues in the markets,” Alan Howard, co-founder of Brevan Howard, said at the opening ceremony in September. “We must involve the brightest minds and finest universities if we are to make financial markets work for everyone. By bringing Franklin Allen and Douglas Gale to Imperial College London, we have done precisely that.”

Banks Team Up With U.K. Government to Combat Cyber Threats and Other Crimes

The British Bankers Association plans to launch in early 2015 a financial crime alerts service. The service is intended to allow banks to react more quickly to major incidents and cyber threats and allow industry financial crime professionals to spot emerging problems.

The service will gather real-time intelligence from 12 partner agencies and government bodies—including the National Crime Agency—and will include warnings on terrorist financing, money laundering, bribery and corruption, and cyber and e-crime.

“This alerts system is a powerful new weapon against fraudsters, cyber criminals and other crooks intent on stealing our customers’ money,” said Anthony Browne, chief executive of the BBA.

CFTC and ASIC Team up on Cross-Border Oversight

The Commodity Futures Trading Commission and the Australian Securities and Investments Commission on Sept. 30 entered into a memorandum of understanding to cooperate and exchange information in order to supervise and oversee regulation of entities that operate on a cross-border basis in the U.S. and in Australia.

Through the MOU, the CFTC and ASIC

expressed their willingness to cooperate in the interest of fulfilling their respective regulatory mandates. The scope of the MOU includes markets and organized trading platforms, trade repositories, and intermediaries, dealers, and other market participants.

The MOU builds on previous agreements signed by Australian and U.S. regulators and is not intended to alter previous agreements.

CME Approved to Offer IRS Clearing in Australia

CME Group obtained approval from the Australian authorities to offer clearing in Australia. The license allows CME to clear interest rate swaps for Australian banks and other market participants, and provide portfolio margining of these swaps with interest rate futures traded on CME. Two other clearinghouses—ASX Clear, the Australian-based clearinghouse owned by ASX Group, and LCH.Clearnet—also provide clearing for IRS in Australia.

“We are pleased to be awarded a clearing and settlement facility license in Australia as we expand our offerings to meet the risk management needs of our growing global client base,” said Sunil Cutinho, president, CME Clearing. “Market participants in Australia now have the option of directly accessing CME Group’s clearinghouse in the United States, where they can achieve greater capital efficiencies and reduced operational risks as a result of margin offsets between their cleared OTC and listed derivatives positions.”

U.S. Options Exchanges Adopt Risk Control Standards

On Sept. 29, the U.S. options exchanges and the OCC, the options industry’s clearinghouse, announced the adoption of risk control standards designed to reduce the risk of loss from errors or unintended activity.

The risk controls include price reasonability checks, drill-through protections, activity-based protections, and kill-switch protections.

The standards will be implemented through an OCC rule that will apply a principles-based approach to options transactions.

In addition, OCC will impose an additional charge starting in June 2016 for trades executed at exchanges that have not demonstrated compliance with the standards.

Exchanges Battle over Dutch Options Market

Competition is ramping up in the Dutch equity options market, one of the biggest retail options markets in Europe.

The Order Machine, an Amsterdam-based multilateral trading facility, has captured approximately a third of the market from Euronext and is gaining support from other players in the market. Euronext is fighting back with a fee reduction, and IntercontinentalExchange has entered the competitive arena through the acquisition of a majority stake in the clearinghouse that supports TOM.

TOM is owned by a consortium of firms including ABN AMRO, Binck Bank, IMC, Optiver and Nasdaq OMX. Its trades are cleared by Holland Clearing House, which was owned by ABN AMRO until the deal with ICE. ICE operates five other clearinghouses in North America, Europe and Asia.

Euronext is fighting back by reducing the fees charged for trading its Dutch options contracts by more than half. Market participants said the fee reduction brings the two markets more or less level.

“Our financial derivatives franchise is strong, but under-exploited,” said Adam Rose, head of financial derivatives at Euronext, which was spun out of ICE in June. “We hope that this action will further drive growth and liquidity in our Dutch options market which is very popular amongst retail investors.”

NYSE and CBOE Take Contrasting Approaches to Market Surveillance

The Chicago Board Options Exchange and C2 Options Exchange have entered into talks with the Financial Industry Regulatory Authority, the self-regulatory organization for the U.S. securities industry, to provide regulatory services to the two exchanges.

If CBOE and Finra reach an agreement, it may include the transition to Finra of



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certain staff in CBOE's regulatory services division involved in the CBOE and C2 regulatory oversight process as well as some staff in CBOE's systems development group, who support options surveillance. CBOE Futures Exchange is not expected to be part of this agreement.

Meanwhile NYSE Group is moving in the opposite direction. In October it announced that it would not renew its contract with Finra, under which the SRO conducts market surveillance, investigation and enforcement functions for NYSE exchanges. Instead these functions will be conducted by NYSE Regulation, an independent arm of the company, starting in January 2016.

The NYSE announcement affects its two options exchanges—NYSE Arca Options and NYSE Amex Options—and its three equity exchanges. Finra will continue to conduct the registration, testing and examinations of broker-dealers that are members of NYSE exchanges.

"We believe the effectiveness of these functions is integral to the operation of our exchanges and to market integrity, fairness and investor confidence," NYSE Group President Tom Farley explained in a state-

ment. Mary Brienza, the chief executive officer of NYSE Regulation, added that her division's "expertise and proximity to the markets being regulated" will enhance market surveillance and rule enforcement.

As part of the planned transition away from Finra, NYSE Regulation selected Cinnober as a technology partner to develop and implement an enhanced oversight system. In addition, NYSE Regulation hired Adam Wasserman, a lawyer at Dechert, as head of enforcement.

CME Starts Venture Capital Arm

CME Group has established a strategic investment group, Liquidity Ventures I, to take minority stakes in early stage technology companies whose innovative products and services may impact CME Group's business in the long term. The investment group typically will co-invest with venture capital firms and strategic investors.

Officials at CME said that since forming the group, CME's investing team has evaluated more than 150 potential investment candidates, with the potential to invest roughly \$500,000 to \$5 million into each company.

One of its investments is in Dwolla, a firm that provides users with an independent platform to send, receive and request funds from other users on the platform. CME also has invested in Wickr, which was founded by privacy advocates and cryptography experts and allows people to communicate privately, using military-grade, patented encryption technology. The Wickr application enables secure, authenticated communication within a company and between a company and its customers.

1QBit is another firm in which CME has taken a stake. This quantum computing software development company provides a framework for practitioners to access the power of quantum computing without having to understand the underlying complexities. The firm offers software that reformulates financial problems into a format that speaks natively to the only commercially operating quantum computer, the D-Wave II. This computer offers significant speed improvements in solving very complex, computationally intensive problems and could ultimately be used for portfolio optimization and risk management issues at quantum speed. ■