



Financial Regulation Decoded

FAQ

ALERT

- Benchmarks
- Central Trade Manager
- Connect
- CrossCheck
- OASYS
- OASYS Global
- OASYS-TradeMatch
- ProtoColl
- TradeHub
- TradeSuite

How the OTC Space Will be Affected:

Q. What are the relevant provisions in Dodd-Frank regarding regulating OTC derivatives that could have an impact on Omgeo's services?

A. The Dodd-Frank Act will enhance federal regulation of the OTC derivatives markets in many important ways. In an effort to reduce counterparty risk and increase OTC market transparency, the Act has mandated the use of central counterparties and derivatives exchanges under certain circumstances. In the US, regulatory reform includes a requirement to trade on an exchange and centrally clear "standardized" derivatives trades, leaving the regulators (SEC and the CFTC) and clearing houses to determine exactly what qualifies as "standard." The logic in the Act runs as follows:

- If a derivatives contract is accepted by one or more central clearing counterparties for clearing then that contract is considered standard, and if a contract is considered standard then it must trade on an exchange.
- Not all OTC derivatives trades will be eligible for clearing so there will continue to be an OTC derivatives market.
- Existing trades (those on the books prior to enactment) will not be required to be cleared. It's Omgeo's assumption that the plain vanilla derivatives, which account for a majority of volume, will be on exchanges (this is TBD by the regulators).

Q. What about EU Regs?

A. It is clear that the Committee of European Securities Regulators (CESR) also favors some form of standardization of OTC Derivatives and use of exchanges. The US is ahead in terms of having passed a bill that is now the law of the land. Europe's position on many of these issues is still evolving although generally the European approach does not seem to be as heavy handed as the US law. You can bet that the US will pressure Europe to tighten up their measures for fear of regulatory arbitrage. Some observations from CESR:

- CESR believes that trading on organized markets could deliver a number of benefits like providing a higher level of transparency, enhancing liquidity, ensuring efficiency and risk reduction and providing an easy access for market participants.
- There's a small number of limitations or pre-requisites to exchange trading of derivatives that may explain why the OTC segment of the market remains very large: the need for the contracts to be standardized, the inability to customize contracts according to individual customers' needs and the limited possibility for products innovation.
- As a preliminary opinion, CESR is in favor of incentivizing the use of organized trading venues but continues to consider whether mandatory usage is desirable, taking into account the discussions currently taking place on this issue in other jurisdictions.
- CESR would like to further explore with market participants which kind of incentives could effectively promote exchange trading.

But the devil's in the details and those details have yet to be written on both sides of the Atlantic. In many cases the legislators are not specific in how new rules should be implemented and have left many details for securities regulators to apply.



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Q. What about the other parts of the bill, Volker Rule and Prop Trading?

A. These parts of the bill will have some impact on the OTC market but little impact on Omgeo offerings like ProtoColl and CrossCheck.

- Lincoln Amendment (push-out provision) – requires government insured banks to spin-off their derivatives trading desks into separate legal entities under the corporate umbrella. However, during the debate and compromise, this amendment was watered down to allow banks to keep interest rate and equity swaps trading inside the bank. (interest rate derivatives are by far the largest type of derivatives in terms of trading and notional value)
- Volcker Rule – limits banks' ability to engage in proprietary trading. This is still a very gray area and will be defined by the regulators. Serious questions arise as to the definition of prop. trading versus hedging the banks' risks from trading for the benefit of their clients. Market making could also be construed as proprietary trading.
- Both of these provisions will make it more expensive for banks to trade OTC but these costs will once again be passed on to customers/tax payers.

Q. What is the impact for ProtoColl and CrossCheck when OTC derivatives go onto exchanges and become cleared?

A. There will be a fairly large impact of OTC trade volume as it shifts onto exchanges. As such, a majority of these new contracts will be traded on exchanges and cleared through a Central Counterparty (CCP). While the CCPs will now manage collateral and have the final say on collateral owed and due on cleared transactions, the buy-side will retain a fiduciary responsibility to manage collateral with their clearing broker (FCM) or directly with the central counterparty. In other words, there will be no disputes when it comes to cleared standard transactions. However;

- *There still will be a market for custom OTC trades when buy side firms need to hedge very specific portfolio risk.*
- *Only new contracts will be required to move to exchanges and be centrally cleared. This leaves a market of more than \$600 trillion of outstanding derivatives positions on the books of institutions that still needs to be proactively collateralized, managed and reconciled (hence the need for tools like ProtoColl and CrossCheck).*
- *These contracts are long term and often last for years, they are simply not going away any time soon.*
- *Still need to reconcile instruments which go beyond OTC Derivatives and Omgeo products have the capability to do that, see below.*

Q. Does the new bill hinder Omgeo's ability to manage collateral for other collateralized asset classes?

A. No, ProtoColl and CrossCheck were designed to manage collateral and reconcile positions that go beyond OTC Derivatives. This includes but is not limited to, Sec Lending, Repo, FX Forwards, and TBAs. This represents a large segment of the collateralized markets and remains a major operational challenge for institutions.

Q. When is Dodd-Frank going into affect?

A. Congress set out the broad outlines of the regulation; it has left the details to be completed by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), with input from federal banking regulators (FBR) such as the Federal Reserve Board. The Bill requires these agencies to write related rules (with some exceptions) no later than July 16, 2011, which is the general effective date of the new law.

Something to note; Although the administration has set this aggressive July 2011 timeframe, one only has to look at the time it took to build CLS (more than 10 years) to understand that this date more than likely will be pushed out significantly.



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Q. What Omgeo thinks might happen

A.

- Plain-vanilla swaps will be cleared without affecting current margin levels significantly.
- Regardless of whether an OTC contract is cleared or not, capital charges to maintain derivatives positions will increase. There remains a concern that liquidity may be negatively impacted if firms need to set aside more capital to protect themselves from a defaulting counterparty.
- Bespoke or structured swaps will not generally be cleared but will require higher margin and must be reported to a regulated repository.. There may well be a period of significant dislocation in this market, as regulators, dealers, and non-dealer counterparties come to terms with just how difficult the task of analyzing risk and assigning margin and capital requirements really is.
- Portfolio margining, netting, hedge margining, and similar concepts will be very difficult to build into the non-standardized swap margining and collateralization models.
- Clearing platforms will be scrutinized by buy-side counterparties to ensure that collateral is segregated, can be ported to a solvent alternative counterparty.
- The CFTC will assert itself as the primary regulator of derivatives.
- Regulators may well construe the “dealer” definition narrowly, to include for the most part only traditional dealers in the market.
- The CFTC and SEC will pressure foreign regulators to develop comparable or complementary regulatory structures to avoid regulatory arbitrage by U.S. market participants. That may take longer to accomplish than the period until effectiveness of the new U.S. scheme, leaving open, for a time at least (or potentially indefinitely), the possibility of an increase in off-shore activity.

Q. If OTC derivatives are centrally cleared and traded on exchanges who manages the collateral?

A. The CCPs will manage the collateral and determine what collateral is pledged/owed. Some are actually considering imposing a fee to manage the collateral. The CCP will issue calls and return collateral based upon their own pricing models and margin calculations. There is little opportunity for a member to dispute.

Q. How is the buy-side affected by this regulation?

A. TBD, based on the specific rules to be written by the regulators in the coming months. The bill applies to “major swap participants” or those who maintain a “substantial position” in swap transactions or otherwise create “substantial counterparty exposure.” The bill does not objectively define “substantial” and will leave to regulators to determine. It can be assumed that large fixed income will be required to use exchanges and CCPs for their standardized derivative trades. Large buy-side companies still will find value in tools like ProtoColl and CrossCheck given the non-standardized off exchange trades, legacy (pre Dodd-Frank) OTC positions, and the additional asset classes and activities that need to be collateralized.

Q. How do the ISDA best practices come into play? Are their recommendations still important?

A. The FED letter commitments are still very important although Omgeo expects that the industry will be making fewer voluntary commitments in the future given the regulatory pill they have to swallow as a result of Dodd-Frank. The best practices around reconciliation, automated collateral calls and dispute resolution to name just a few will continue to be adopted by the industry and expected by the Fed. Dodd-Frank starts where those commitments left off.



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Q. As a client, why not wait to buy ProtoColl or CrossCheck until everything is outlined and on paper?

A. It's a valid concern, however it's clear that in the US and EU, there will be regulatory change which will ultimately allow for an admittedly smaller but still present OTC marketplace. Clearing of OTC derivatives is only one aspect of managing risk and will not eliminate bi-lateral counterparty risk. The business case or legal requirement for buy side swap participants to clear OTC trades remains uncertain. More important are the additional asset classes mentioned above which still need to be managed and reconciled on a regular basis and these asset classes will not be affected in any way by the proposed regulation. Every buy-side firm with material collateralized portfolios will need to show prospective customers, internal compliance and external regulators that they have a process in place to manage customer collateral. The new environment makes it no longer just a nice-to have.

The views expressed in this document are the opinion of Omgeo and its interpretation of the regulations.



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