DECONSTRUCTING DODD-FRANK

A SPECIAL SERIES ON THE FINANCIAL REFORMS

Regulation of Over-the-Counter Derivatives

The recently enacted Dodd-Frank Act and the European Commission's proposed regulation of over-the-counter (OTC) derivatives both require expanded use of central clearing of derivative contracts. Eric Berman of Practical Law Company reached out to Michael Sackheim, Elizabeth Schubert and Antony Bryceson of Sidley Austin LLP to discuss their views on how the regulation of OTC derivatives will impact end-users.

PLC: *In general, how has the market responded to the regulatory overhaul of derivatives under the Dodd-Frank Act?*

SCHUBERT: We have not seen any rush towards clearing derivatives. So far, actions that end-users are taking in response to the Act's passage have been limited (by end-users, we are referring to consumers of derivatives products, not the financial institutions that provide them). This is because we do not yet have much definition on exactly what the Act requires. However, we have fielded a small number of inquiries, such as questions about which clearinghouse is best suited for a particular client. While it is still early in the process and much remains to be determined, we will learn shortly which products must be centrally cleared. At that time we anticipate that the existing clearing platforms will change and new clearinghouses will develop.

SACKHEIM: The imposition of new position limits across the futures and swaps markets affects all of our trading clients, especially multi-faceted financial institutions. An important change that clients are concerned about is that collective investment vehicles that trade OTC swaps will now be regulated by the CFTC as commodity pools. Because of a change in Title VII to the definition of an "eligible contract participant" (ECP), a commodity pool with less than $10 million in assets whose investors are not all ECPs will not itself be considered an ECP for certain forex trading purposes under the Commodity Exchange Act Section 2(c) retail forex regime, causing the commodity pool to be considered a "retail" client under the CFTC's new retail forex rules.

>> For a detailed explanation of key provisions of the Dodd-Frank Act relating to swaps and derivatives, search Summary of the Dodd-Frank Act: Swaps and Derivatives on our website.

PLC: *In Europe, a broad equivalent to the Dodd-Frank Act emerged on September 15, 2010 in the form of the European Commission's proposed regulation of OTC derivatives, central counterparties and trade repositories (Regulation). What are the core aspects of the Regulation?*

BRYCESON: The thrust of the proposed Regulation is to expand the use of central clearing, including an obligation to clear all eligible derivative contracts with central counterparties and an obligation to report all OTC derivative contracts to trade repositories. The obligation to clear applies to "eligible" trades whereas the reporting obligation applies to both "eligible" and "non-eligible" trades. In broad terms, the European Securities and Markets Authority (ESMA) will identify eligible classes of derivatives that must be centrally cleared by reference to risk

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Michael Sackheim
PARTNER
SIDLEY AUSTIN LLP

Michael Sackheim is a Partner in the Securities and Futures Regulatory Group in the firm's New York office. He regularly advises end-user clients on derivatives and commodities matters.

Elizabeth Schubert
PARTNER
SIDLEY AUSTIN LLP

Elizabeth Schubert is a Partner in the Investment Funds, Advisers and Derivatives Practice Group in the firm's Chicago and New York offices. She advises end-user clients on derivatives matters.

Antony Bryceson
COUNSEL
SIDLEY AUSTIN LLP

Antony Bryceson is Counsel in the Investment Funds, Advisers and Derivatives Practice Group in the firm's London office. He advises end-users such as hedge funds on their custody, trading and financing arrangements.

profile, liquidity, availability, pricing information and the ability of central counterparties to handle a certain volume of contracts.

PLC: *What are the primary issues of concern for end-users as a result of these US and European regulatory developments?*

SCHUBERT: One major issue is central clearing and which products will be subject to this requirement. Another question on the minds of many clients is who will need to register as a Major Swap Participant, Major Equity Swap Participant or Swap Dealer. Clients have also expressed some concern about confidentiality in the context of the new reporting requirements as well as increased costs due to new margin and capital requirements. Central clearing and collateral segregation present new factors to evaluate when managing counterparty risk. An issue that is slightly off the radar for many end-users is that some may have to register as commodity pool operators or commodity trading advisors by the end of the year. The Dodd-Frank Act significantly expands the reach of the Commodity Exchange Act. Changes include expansions of definitions of commodity pool, commodity pool operator and commodity trading advisor to include those that advise on swaps other than security-based swaps.

SACKHEIM: End-users will need to learn to negotiate clearing agreements in addition to swap agreements. Some dealers may be considering developing clearing departments and new unified agreements for the clearing of both futures and swaps, which will impact customer margin requirements and may also affect other trading relationships, such as prime brokerage.

BRYCESON: In Europe, we can expect broadly similar issues to apply. There are likely to be increased costs, which will be passed on to the end-user, and higher margin requirements. End-users will, under the proposed Regulation, also need to negotiate clearing agreements. These clearing agreements will have certain features in common with "give-up" or OTC prime brokerage agreements under which a dealer intermediates between two OTC counterparties. They will also have certain features in common with traditional futures clearing agreements.

PLC: *Do you expect compliance with the new regulations will be onerous or prohibitive for end-users?*

SACKHEIM: Clients are certainly concerned about the possibility of onerous requirements. As it currently reads, the Dodd-Frank Act casts a wide net and could subject many end-users to registration, reporting, margin, capital, business-conduct and other requirements. In addition, all end-users will be subject to position limits to be imposed by the CFTC and SEC. Depending on how the CFTC characterizes hedging, some traders may find that their use of futures and derivatives for risk mitigation purposes may be curtailed, especially if their positions must be aggregated with trades of their affiliates. However, until the new regulations and definitions of key terms are set, we cannot tell how wide-reaching the Act will be.

Our end-user clients are hoping that the upcoming rules will take a reasonable approach to the issue of the registration of major swap participants by singling out only those entities that pose systemic risk. Prevention of systemic risk, after all, is the overarching purpose of the legislation. Our clients are being proactive and participating in the rulemaking process by submitting comments and meeting with regulators to voice their views. We have seen increased interest in this lately and have been actively assisting our clients in this process.

PLC: *Once the implementation phase for the Dodd-Frank Act is complete, how do you anticipate the costs of doing business will change for end-users of derivatives?*

SCHUBERT: I think it is reasonable to expect that the increased collateral and margin requirements will entail additional costs. This is because of both the cost of capital and the opportunity costs associated

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with the re-allocation of capital to meet these new requirements. In the days of trading without a central clearing requirement, a client that had a complex trading relationship with its swap provider or prime broker counterparty that crosses product lines, such as prime brokerage, OTC derivatives and repurchase agreements, would be assessed margin based on the counterparty's aggregate exposure to the client across all products. For example, a client with exposure to a security in its prime brokerage account and an offsetting OTC position under its ISDA Master Agreement might not have to post very much margin.

Central clearing will make cross-margining in this manner much more difficult to do. Positions under different product lines are likely to be assessed margin on a stand-alone basis. As a result, clients will likely have to post more collateral in the aggregate across all their trades than they used to. The new compliance regime will also require more time and money to implement and monitor. However, if the swap execution facilities actually work as price discovery mechanisms, it is possible that spreads on cleared transactions will narrow and transaction costs may come down as market efficiency is enhanced.

PLC: *How does managing counterparty risk change under the Dodd-Frank Act? Does central clearing and the independent custody requirement for holding counterparty collateral make managing counterparty risk easier?*

SCHUBERT: The goal behind these changes is to reduce systemic risk. It is important for end-users to understand that these changes will accomplish this but they do not eliminate counterparty risk. The rationale that central clearing will reduce systemic risk is based on three key principles:

- Portability of open positions.
- Loss mutualization.
- Segregation of margin.

An important consideration on any clearing platform is what happens when an end-user's clearing member counterparty becomes insolvent (for example, whether collateral it has posted will be returned directly to the client or to the clearinghouse). If a client has elected for portability of positions, meaning that, upon the insolvency of its clearing member, its positions will automatically "port" to a solvent clearing member, it will need to understand the portability mechanics. Key issues are whether porting will occur automatically upon a clearing member's insolvency and whether the client will have input regarding who becomes its new clearing member counterparty. In addition, the client will want to understand whether its collateral will port automatically with its positions or whether it may have to post collateral to its new clearing member while it is waiting for its collateral to be returned from the insolvent clearing member.

Loss mutualization refers to the fact that all participants in a clearinghouse will share equally in losses resulting from the insolvency of a clearing member or clearinghouse. As a result, a critical issue for clients to understand is how the collateral waterfall works in this situation. Specifically, the client will want to know the extent to which its collateral assets are at risk when its clearing member or another customer defaults.

Segregation of client collateral improves a client's ability to recover these assets upon a counterparty's insolvency, but many factors play a role in determining how effective these arrangements are. A main factor to consider is where the collateral account is held. We generally take the view that a tri-party custody arrangement offers the best protection. In addition, the type of account, the type of investments permitted for assets in the account, whether rehypothecation applies and how the custodian entity is regulated, will all play a role in the effectiveness of a segregated collateral arrangement. We are expecting that clients will negotiate these arrangements heavily for protections that exceed those established by regulation.

PLC: *How does the proposed European Regulation address management of counterparty risk?*

BRYCESON: The proposed Regulation provides a number of prudential requirements to guard against default by central counterparties. These include a requirement that central counterparties must:

- Assess liquidity and credit exposures to each clearing member on a near-real-time basis.

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- Ensure that exposures to clearing members are fully collateralized with highly liquid collateral.
- Maintain a default fund, contributed to by clearing members, to cover losses arising from the default of one or more of its clearing members.

Managing counterparty risk will also involve a measured approach to allocation of trades to clearing members and usage of different central counterparty systems. It is likely that many end-users will benefit from greater netting through the use of central counterparties due to concentration of transactions in a particular central counterparty system. This was one of the benefits of "give-up" or OTC prime brokerage/intermediation where an end-user could consolidate its positions with one OTC counterparty, resulting in reduced exposure and lower overall margin requirements.

PLC: *How significant will the transition be for clients to move toward central clearing and exchange trading?*

SCHUBERT: Moving OTC derivatives to clearing and exchange trading will be a significant change for most end-users, but how significant will depend on the products traded, trading volume and trading strategy. A major adjustment for clients who currently trade OTC derivatives using the ISDA Master Agreement is that many OTC products will now trade under a futures customer agreement when the central clearing requirements take effect. The futures trading model is very different from the bilateral OTC model. In a client's trading relationship with its futures commission merchant, the right to call a default and call for margin belongs exclusively to the futures commission merchant. This differs from the bilateral ISDA model, which gives both parties these rights. Another adjustment will relate to meeting and monitoring collateral obligations. Since each type of OTC derivative product will be cleared separately on a distinct clearing platform, keeping track of disparate margin requirements for each product may be a burden.

PLC: *Which products do you think will be required to be centrally cleared?*

SACKHEIM: The more standardized products will likely be required to be cleared. This may turn out to be most swaps, including interest rate swaps, credit default swaps and commodity swaps (in other words, categories of swaps that are already being cleared today to a certain extent). Currency swaps are also subject to the clearing requirement, but the Dodd-Frank Act allows the Treasury Secretary to recommend to Congress that forex swaps be exempted from mandatory clearing. Beyond these types of swaps, it is difficult to predict at this point which other products will need to be centrally cleared. Under the Act, one of the requirements for a swap to be cleared is that it must be approved for clearing by a regulated clearinghouse. As clearing evolves and various products are tested, the universe of cleared swaps will likely expand. There will likely remain a category of highly structured bespoke transactions that will not be cleared but that will carry greater transaction costs because of imposed margin and capital requirements.

SCHUBERT: The regulators have broad discretion to determine which types of swaps will be subject to the central clearing requirement. Factors that they are to consider in making these determinations under the Dodd-Frank Act include the existence of significant outstanding notional exposures, liquidity and pricing data, as well as effects on systemic risk.

BRYCESON: The proposed European Regulation provides that a contract can be cleared under two methods. Under the first method, the central counterparty would seek approval from ESMA to clear a certain class of OTC derivative contract. Under the second method, ESMA would determine which contracts are eligible for clearing. Generally, we can expect the range of products which are centrally cleared to increase.

PLC: *Will end-users benefit from the central clearing requirement?*

SACKHEIM: The main goal of central clearing and the use of the clearinghouse "guarantee" is the prevention of systemic risk. Many end-users, especially those that are financial entities, lost a significant amount of money during the Lehman debacle. Therefore, keeping risk transparent and dispersed is certainly in line with their interests. Portability of transactions from an insolvent clearing member to a solvent clearing member, a concept copied from

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practice on the futures exchanges, is a significant benefit for end-users.

On the other hand, end-users will lose the flexibility to tailor transactions to meet their investment objectives. Many of our clients that are commercial end-users are concerned that the increase in standardization will prevent them from properly hedging their business risks. For these clients, clearing may not be very attractive. Also, the impression we have so far is that most clients believe central clearing will increase the cost of derivatives trading, either directly or by pass through from the dealer clearing members. Finally, even if we assume that clearing will result in a net positive, it still must be properly implemented to bring about that result.

SCHUBERT: The benefits of central clearing are likely to come at a cost — most notably, increased capital and margin requirements. It is also possible that position limits may have a chilling effect on innovation. A benefit that may result from central clearing is more transparent pricing, narrowing bid-ask spreads and reduced transaction costs. Ideally, this represents a natural evolution of the OTC market that will increase trading volumes and liquidity. But this all depends on how well the swap execution facilities do their job.

BRYCESON: My view is that the standardization of a number of OTC products will be a natural evolution for the OTC derivatives markets, resulting in increased liquidity. Transparency will be viewed as a risk mitigator and central clearing will be considered good for market stability. In ten years' time, end-users will take for granted the risk profile and user-friendliness of central clearing markets. From a purely legal/contractual perspective, end-users will be subjugated to the rules of the clearinghouse in which their trades are cleared, although one would hope that these rules will be accepted in the way that rules of futures exchanges generally are. The imposition of clearinghouse rules on OTC products will result in a greater certainty for both clearing members and end-users when compared to traditional non-cleared OTC transactions between two parties, which rely on negotiated bilateral terms where no such rules apply.

>> For a Practice Note on the Dodd-Frank Act, including links to summaries of certain key provisions of the Act, search Road Map to the Dodd-Frank Act on our website.

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