GLOBAL

LEVERAGE RATIO

ECB and Fed Officials Back Leverage Ratio Recalibration to Ease Impact on Clearing

Two influential regulatory officials have indicated that they share the widespread concerns within the derivatives industry regarding the impact of Basel III capital requirements on clearing firms. Although they expressed these views as individuals, their comments suggest that banking regulators are recognizing that the treatment of cleared derivatives under Basel III should be reviewed.

In an article published on April 20, Benoît Cœuré, the chairman of the Committee on Payments and Market Infrastructures, a key standard-setting body at the international level, encouraged banking regulators to consider the impact of the Basel III capital standards on derivatives clearing. He warned that the reduction in the number of clearing members could have implications for systemic risk.

"The prospective further concentration of client clearing business in a smaller number of clearing members would further increase the respective financial risk concentration and could limit the ability to port client positions and collateral in case of member default, heightening potential systemic spillover risks," wrote Cœuré, who is also a member of the European Central Bank's governing board.

Also on April 20, Federal Reserve Governor Jerome Powell discussed the unintended consequences of including initial margin in the leverage ratio. Speaking at an event in Washington, D.C., Powell noted that regulators want to see the adoption of clearing, but the leverage ratio makes it more expensive. "We are undermining the clearing mandate and the ability of smaller clients to get their products centrally cleared. I think we need to look again at the calibration of the leverage ratio in the U.S.," said Powell.

Market participants have been warning for some time that the capital requirements stemming from the leverage ratio will harm the strength and stability of the cleared derivatives markets worldwide unless it is amended to recognize the exposure-reducing effect of the collateral that clearing banks collect from their clients.

Last November, a coalition of 15 industry bodies representing clearing members, asset managers, insurance companies, commodity end-users, hedge funds, derivatives exchanges and clearinghouses sent a joint letter outlining their concerns to Mark Carney, the chairman of the Financial Stability Board, Mario Draghi, the chairman of the Group of Governors and Heads of Supervision,

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and Stefan Ingves, chairman of the Basel Committee on Banking Supervision.

"We believe that the leverage ratio, as presently constructed, has certain unintended consequences that will make the financial system more fragile, severely undermine the global efforts to bring more derivatives in central clearing, and seriously impair the ability of end-users in the real economy to hedge their market risks," the groups said in the letter.

GLOBAL GUIDELINES

World Federation of Exchanges Publishes Cyber-Resilience Standards

The World Federation of Exchanges, which represents more than 200 exchanges, clearinghouses and other market infrastructure operators, published a set of cyber-resilience standards in April. The new standards, which are voluntary, are meant to ensure alignment and common minimum standards for trading venues around the world.

The standards build out a set of cyber-resilience principles that the WFE issued last September. The standards cover eight key areas: strategy and framework; governance; risk identification; protection and controls; monitoring and detection; response and recovery; information sharing; and testing, situational awareness, learning and evolution.

"These guidelines serve as the building blocks upon which WFE members and other global market infrastructure providers can base their individual approaches to cyber," said Nandini Sukumar, WFE's chief executive officer.

PROJECT KISS

Giancarlo Outlines Plan to Transform CFTC's Approach to Regulation

On March 15, Chris Giancarlo, the acting chairman of the Commodity Futures Trading Commission, announced a three-pronged plan to renovate derivatives regulation that he called Project KISS, which stands for "keep it simple, stupid."

Giancarlo, who has been nominated to chair the agency by President Trump, said the CFTC must "reinterpret its regulatory mission" in line with the goals of the Trump administration, focusing on three main themes: fostering economic growth, enhancing U.S. financial markets, and "right-sizing" the CFTC's regulatory footprint.

This will include an agency-wide review of CFTC rules, regulations and practices to make them "simpler, less burdensome and less costly," Giancarlo said. He emphasized that this review is not aimed at repealing regulations, but rather applying these rules in ways that put less drag on the U.S. economy.

Giancarlo, who gave the speech at FIA's 42nd International Futures Industry Conference in Boca Raton, also announced steps to restructure the agency by moving market surveillance functions into the enforcement division and creating a new office of "market intelligence" that will seek to understand trends in trading behavior and market dynamics.

Giancarlo also said the CFTC should continue to work with its overseas regulatory counterparts and international standard-setting bodies. "As our regulatory counterparts continue to implement swaps reforms in their markets, it is critical that we make sure our rules do not conflict and fragment the global marketplace," he said.

He also vowed to change the CFTC's rule-making process, focusing on "greater care and precision in rule drafting, more thorough econometric analysis, less contracted time frames for public comment, and a reduced docket of new rules and regulations to be absorbed by market participants."

In May, the CFTC followed up on Giancarlo's pledge by issuing a formal call for external input on Project KISS. Market participants and other interested parties have until Sept. 30 to submit their recommendations.

CLEARING RISK

Market Participants Voice Concerns about Ability to Port Clients after a Default

Customers may not be able to find a new home for their cleared derivatives if their clearing member goes into default, several industry participants warned the Commodity Futures Trading Commission at an April 25 meeting of the CFTC's Market Risk Advisory Committee.

Executives from banks, trading firms and clearinghouses commented that even though "porting" of customer positions worked successfully in past instances of clearing member defaults, they are not certain that it will work going forward. One reason is the introduction of the Basel III leverage ratio, which has made it more expensive for clearing members to hold customer margin. This has raised a concern that clearing members will be unwilling to take on new business during a period of market stress.

Dale Michaels, executive vice president for financial risk management at OCC, the U.S. equity derivatives clearinghouse, urged regulators to address this concern to ensure portability in a stressed situation, and noted that some of OCC's members have cut back on providing clearing services because of the capital requirements. This concern is "no longer theoretical," said Michaels. "Even in peace time, clearing members are asking business to leave."

Sebastiaan Koeling, managing director at Optiver U.S., the Chicago-based subsidiary of the Dutch trading firm, added that the leverage ratio is reducing the availability of clearing for market makers, which in turn is reducing their ability to provide liquidity. He added that porting will be particularly challenging for options market makers. There are only three clearing firms that have the ability to provide cross-margining for trading

firms that make markets in both equities and options, he explained, and if one of these clearing firms were to default, the other two would be unlikely to take on its customers.

Ed Pla, head of clearing and execution at UBS, noted that in addition to the leverage ratio, several other factors have come into play since the introduction of mandatory clearing for swaps. These include an increase in the notional amounts being cleared, a decrease in the number of clearing members, and a concentration of market share among clearing firms, especially among the firms that clear swaps. Pla expressed concern about these trends and warned that porting is “very untested in the new regime.”

CFTC staffers echoed these concerns. Robert Wasserman, chief counsel in the agency’s clearing and risk division, commented that when Refco failed in 2005, several futures commission merchants competed for the firm’s customer accounts. When Lehman Brothers failed in 2008, only one firm stepped forward to take that firm’s customer accounts, and when MF Global failed in 2011, the customer accounts had to be split up among multiple firms. “The trend line has been going in the wrong direction,” he said. “The ability to find homes for customers [has become] much less likely.”

AUTOMATED TRADING

FIA and FIA PTG Decry CFTC’s Prescriptive Approach

On May 1, FIA and the FIA Principal Traders Group submitted a joint comment letter opposing overly prescriptive regulation of automated trading. The comment was filed in response to the Commodity Futures Trading Commission’s supplemental notice of proposed rulemaking regarding Regulation AT.

The comment letter detailed the principles that should form the basis of any automated trading regulation, and offered recommendations on risk controls, testing, order cancellation tools and unique identifiers. The letter also expressed the groups’ opposition to the CFTC’s proposal to access proprietary source code used to operate automated trading systems without the legal protections provided by the subpoena process.

“Proposed Regulation AT is too prescriptive and is neither necessary nor appropriate to address the risks of automated trading,” said Walt Lukken, president and CEO of FIA. “If the Commission still finds it necessary to move forward with regulations, we recommend replacing the current proposal with a principles-based approach that recognizes the importance of risk controls in protecting our markets while encouraging market innovation by being flexible enough to adapt to the pace of technological advances.”

The letter represents FIA and FIA PTG’s third comment letter on this proposed regulation. Additionally, FIA and FIA PTG provided a detailed response to the CFTC’s 2013 concept release on risk controls and system safeguards for automated trading environments. These comments build upon industry-wide surveys of risk management procedures and six papers on best practices and guidelines for automated trading systems.

TRUMP NOMINATION

Senate Confirms Clayton as SEC Chairman

On May 2, the Senate confirmed the nomination of Jay Clayton to serve as chairman of the Securities and Exchange Commission. The nomination was approved in a 61 to 37 vote, with several Democrats joining their Republican colleagues in supporting the nomination. He was sworn into office on May 4.

Clayton, formerly a partner at the law firm of Sullivan & Cromwell, brings to the agency years of experience advising financial corporate executives on how to raise capital and engage in mergers, acquisitions and spin-offs.

During the Senate hearing on his nomination, Clayton stressed that as SEC chairman he will focus on encouraging more companies to raise capital in the stock markets. He noted that the number of initial public offerings has declined in recent years, and said he will seek to reduce the burdens of becoming a public company. Regarding enforcement, he said regulators could achieve more by suing individuals rather than pressuring companies to pay large fines.

While in private practice, Clayton advised a long list of public and private companies on a wide range of matters, including securities offerings, mergers and acquisitions, corporate governance, and regulatory and enforcement proceedings. During the financial crisis, he advised Bear Stearns on its sale to J.P. Morgan, Barclays in its purchase of the core U.S. business of Lehman Brothers shortly after that firm’s bankruptcy, and Goldman Sachs in its negotiations with Warren Buffett on a $5 billion infusion of capital.

In 2014, he advised Alibaba, the Chinese ecommerce company, on its initial public offering. That offering raised $25 billion, making it the largest IPO in U.S. history. He also has experience with commodity trading firms. In 2012 he advised a group of investors that formed Castleton Commodities through the purchase of the energy trading joint venture backed by Louis Dreyfus and Highbridge Capital. Three years later he advised Castleton on its acquisition of Morgan Stanley’s oil merchant business.

MORE ONLINE

SHORTER SETTLEMENT

SEC Adopts T+2 Settlement Cycle

On March 22, the Securities and Exchange Commission approved a rule that will shorten the standard settlement cycle for most securities transactions to T+2 from

T+3. Broker-dealers will be required to comply with the shorter settlement cycle beginning on Sept. 5.

"Transition to a T+2 settlement cycle will reduce by one business day the time horizon for risk exposures as well as for potential liquidity pressures, which should yield other benefits for market participants and the clearance and settlement infrastructure as a whole," Michael Piwowar, the SEC's acting chairman, said in a statement.

The main impact for derivatives market participants will be on exercises and assignments for equity options. To help market participants prepare, the OCC, the clearinghouse for U.S. equity options exchanges, has set up a schedule of tests taking place over the next several months.

FINTECH IN FOCUS

Canada's AMF Forms a Fintech Lab and Joins Blockchain Partnership

Quebec's financial regulator, the Autorité des Marchés Financiers, has created an internal think tank to explore applications of new technologies among the entities it regulates, including exchanges and clearinghouses, as well as potential applications to its own regulatory activities.

The AMF also said it intends to form partnerships with key players in the financial sector and academia, and announced the signing of a partnership agreement with R3, an innovation firm focused on building platforms and applications for the financial sector. R3 has established a consortium of financial institutions for developing and applying blockchain technology in the financial services industry.

The think tank, which the AMF is calling its "Fintech Lab," will also serve as a talent incubator, drawing on university students in engineering and technology as interns under the supervision of members of AMF's fintech working group.

The AMF said the lab will focus on four objectives: deepen and update the AMF's knowledge of new technologies; explore how the AMF itself can better use new technologies to improve its business processes; provide advice and insight with respect to a review of the regulatory framework and to the regulatory sandbox initiatives implemented by the Canadian Securities Administrators; and anticipate the AMF's needs regarding the latest expertise and computer systems.

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EUROPE

RULE 1.31

FIA Welcomes CFTC's Plan to Modernize Recordkeeping Requirements

In January, the Commodity Futures Trading Commission issued a proposal to update and modernize Rule 1.31, which sets out certain recordkeeping requirements for futures commission merchants, commodity pool operators, trading firms that are exchange members, and other market participants.

On March 20, FIA filed a comment letter broadly supporting the proposal, welcoming the agency's "technology neutral and principles-based" approach and its effort to remove outdated and irrelevant provisions. FIA recommended a handful of further refinements to the rule, and encouraged the CFTC to work with the Securities and Exchange Commission to harmonize relevant rules for FCMs and broker-dealers.

CLOUD OVER LONDON

EC Mulls Options For Euro Clearing Post-Brexit

On May 4, the European Commission issued a policy statement discussing its plans to issue legislative proposals by the end of June to address "important and emerging challenges" in derivatives clearing.

The statement indicated that these proposals may include a requirement that the clearing of euro-denominated derivatives take place within the European Union, which would have the effect of forcing this business out of London after the U.K. leaves the EU. The policy statement held out the possibility, however, that "enhanced supervisory arrangements" would be sufficient.

The Commission observed that clearing services are concentrated in a limited number of clearinghouses, increasing their importance to financial stability and market functioning well beyond their home country. For this reason, there is a need to enhance the current supervisory arrangements, which tend to rely on home state supervision.

"In this context, the foreseen withdrawal of the United Kingdom from the EU will have a significant impact on the regulation and supervision of clearing in Europe," the Commission said. "At present, as much as 75% of euro-denominated interest rate derivatives are cleared in the U.K. Derivatives denominated in some other Member States' currencies are also cleared in the U.K. These transactions directly impact the responsibilities, including in the area of monetary policy, of the relevant EU and Member State institutions and authorities."

EMIR REVIEW

EC Proposes Changes to Clearing and Reporting Requirements

On May 4, the European Commission published a legislative text proposing changes to the European Market Infrastructure Regulation. The proposed changes, if approved, would ease certain requirements related to derivatives clearing and transaction reporting and reduce costs and regulatory burdens for market participants.

Valdis Dombrovskis, the commissioner in charge of financial services policy, emphasized that the majority of the changes come as a result of the Commission's call for evidence, which sought views from the industry on where post-crisis legislation could be amended to streamline existing provisions and reduce unintended consequences.

"The European Market Infrastructure Regulation is at the heart of the EU's financial reforms," Dombrovskis said. "Today's proposal ensures that EMIR achieves its objective of reducing systemic risk in the OTC derivatives market, while keeping costs to a minimum for the real economy. The proposal builds on the Commission's call for evidence and deepens our capital markets and our efforts to support investment, growth and jobs."

Key elements of the May 4 legislative proposal include the following:

- **Streamlined reporting of exchange-traded derivatives:** Under EMIR, transactions in exchange-traded derivatives must be reported by both sides of the transaction. The proposal introduces single-sided reporting for exchange-traded derivatives and assigns the reporting responsibility to clearinghouses. The Commission said this will "greatly simplify" the reporting process without adversely impacting transparency.
- **Removal of frontloading and backloading requirements:** The proposal would remove the obligation to report historic data on OTC derivatives trades, known as "backloading." The Commission believes that this will significantly reduce costs and burdens on counterparties and result only in a very limited loss of data compared to the current rules. In addition, the frontloading requirement also would be removed. Under the current rules, long-dated trades must be reported as soon as they become subject to mandatory clearing requirements, even if the clearing obligation has not taken effect.
- **Intra-group exemption:** Intragroup transactions involving non-financial counterparties would be exempted from the reporting obligation. The Commission said this would significantly reduce the costs and burdens of reporting for these counterparties without significantly affecting the ability of regulators to monitor systemic risk in the OTC derivative markets.

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- **Temporary suspension of the clearing obligation:** The proposal would give the Commission the power to temporarily suspend any clearing obligation on the basis of a request from the European Securities and Markets Authority. The Commission explained that this power is needed if the clearing obligation becomes impossible to continue or has adverse effects for financial stability. The Commission also noted that this new provision complements the proposed framework for the recovery and resolution of central counterparties by introducing the mechanism for a temporary suspension of clearing obligation in situations other than resolution.
- **CCP transparency:** The proposal would require central counterparties to provide their members with tools allowing them to simulate the amount of collateral requested to clear future trades. In addition, CCPs would be required to make available a thorough description of their initial margin models to their clearing members for them to gain a clear understanding of their reach and their limitations.
- **Clearing obligation for non-financial counterparties:** Contracts by non-financial firms above a clearing threshold will continue to have to be cleared through a CCP. However, the proposed amendments would allow firms to only clear those classes of derivatives which breach the clearing threshold. In addition, only non-hedging contracts would be counted towards thresholds triggering the clearing obligation.
- **Clearing obligation for pension funds:** The proposal would extend by three years the temporary exemption from the clearing obligation of pension scheme arrangements.
- **Clearing obligation for small financial counterparties:** The proposal would establish a clearing threshold for small financial counterparties based on the volume of their OTC derivatives transactions. Only counterparties exceeding that threshold would be required to clear their trades.

COMPETITION IN CLEARING

EC Blocks Deutsche Börse/LSE Merger

On March 29, the European Commission issued a statement prohibiting the proposed merger between Deutsche Börse and London Stock Exchange Group. The Commission concluded that the merger would have created a *de facto* monopoly in the clearing of fixed income instruments.

"The merger between Deutsche Börse and the London Stock Exchange would have significantly reduced competition by creating a de facto monopoly in the crucial area of clearing of fixed income instruments. As the parties failed to offer the remedies required to address our competition concerns, the Commission has decided to prohibit the merger," said Commissioner Margrethe Vestager, who is in charge of competition policy.

LSE had proposed divesting LCH.Clearnet SA, its Paris-based clearinghouse, to remedy the Commission's concerns. While the EC concluded that this divestment would have resolved the concerns relating to single stock equity derivatives, it said the divestment would not have been effective to remedy the impact on fixed income clearing.

"Deutsche Börse is well-positioned on a stand-alone basis to compete at a global level with other market infrastructure players," Carsten Kengeter, CEO of Deutsche Börse, said in a statement. "We will continue to pursue our growth strategy, to strengthen our innovation capabilities and to even better serve market and customer needs," he said.

FROM PARIS TO AMSTERDAM

Euronext Negotiates Derivatives Clearing Agreement with ICE Clear Netherlands

Euronext has signed a binding "heads of terms" agreement with the Intercontinental Exchange to use ICE Clear Netherlands for its derivatives markets.

The two companies said they expect to complete a formal clearing services agreement by the end of the second quarter and expect to migrate Euronext's financial and commodity derivatives to the Amsterdam-based clearinghouse in the second half of 2018.

Under the terms of the agreement announced in April, Euronext will make an "upfront" €10 million investment in ICE Clear Netherlands and will receive income from the provision of clearing services. Euronext also said the deal will lead to lower costs for customers, with a 15% reduction in clearing fees and lower treasury management fees.

Euronext executives said the move was a response to the collapse of the proposed merger between Deutsche Börse and the London Stock Exchange Group. LSE had agreed to sell LCH.Clearnet SA, its Paris-based clearinghouse, to Euronext in order to address antitrust concerns, but the deal was contingent on the merger. Euronext currently relies on LCH.Clearnet SA for derivatives clearing, but the arrangement is due to expire in December 2018.

Euronext CEO Stéphane Boujnah said his company "continues to remain a willing buyer" for the Paris-based clearinghouse, but in the absence of an agreement, "Euronext is fully committed to securing the best long-term solution for its post-trade activities, in the interests of clients and shareholders."

ICE bought a majority stake in the Dutch clearinghouse in December 2014. The clearinghouse currently provides clearing services for equities and equity index derivatives listed on TOM, a multilateral trading facility based in the Netherlands. TOM is in the process of winding down its operations, however.

METALS MARKET MAKEOVER

LME Launches Comprehensive Review of Market Structure and Trading Practices

The London Metal Exchange and LME Clear have published a discussion paper to solicit feedback on a wide range of issues related to its core markets in non-precious metals, including trading and booking structures, clearing structures and services, delivery and physical market structure, membership and the LME ecosystem as a whole.

LME will engage with market participants through a series of briefings and gather written feedback until June 30. After analyzing the feedback, LME intends to publish an outcomes document that will articulate its strategic direction. This document is expected in the fall.

"Our core strategic vision is to work with our members to make LME trading more accessible and efficient, while fully respecting our physical roots," said Matthew Chamberlain, LME's newly appointed CEO. "This paper lays out the principles on which we plan to build our business, and invites feedback from all stakeholders on the routes by which we deliver that strategic vision."

The 50-page discussion paper puts forward a long list of questions on key issues facing the exchange, including whether to preserve the date structure for its contracts or move towards the futures model of monthly contracts; how to deal with high-frequency traders and whether it should introduce "speed bumps" to mitigate the advantages of execution speed; possible changes to its trading and clearing fees; and many other issues related to its market structure.

The paper also raises several issues related specifically to clearing, including a possible transition from SPAN to VaR margining methodology, the creation of different types of client accounts based on gross rather than net margining, and the introduction of an additional OTC clearing service.

ASIA

OTC CLEARING

HKEX Launches Client Clearing for IRS and NDFs

On March 21, Hong Kong Exchanges and Clearing announced that it has launched a client clearing service ahead of the first phase of mandatory clearing in Hong Kong set for July 1. The service provides OTC derivative market participants with the means to fulfill their regulatory obligations along with the credit and capital efficiency benefits of central clearing through the establishment of a clearing relationship with a member of OTC Clearing Hong Kong, the exchange's clearing service for interest rate swaps and non-deliverable foreign exchange forwards. HKEX has also received approval from the Securities and Futures Commission to accept certain types of high-quality, non-cash collateral from its clearing participants to satisfy their margin requirements to OTC Clearing. These include government securities from the U.S., Hong Kong and China.

FUTURES AND OPTIONS CLEARING

Japan's JSCC Amends Rules for Account Structure, Margining and Collateral Management

The Japan Securities Clearing Corporation has implemented several changes to its clearing rules for listed derivatives to enhance its clearing services and to introduce practices adopted by other major global clearinghouses. These include changes to the account structure—both omnibus accounts and individual segregated accounts will now be available for clients. In addition, the clearinghouse has revised its margining rules and its collateral management framework.

EXPANDED ACCESS

India Updates Oversight of Commodity Derivatives

The Securities and Exchange Board of India announced it will issue unified licenses to brokers and clearing members to transact in both commodity derivative and equity markets. This follows the merger of the Forward Markets Commission, which regulates commodity markets in India, and SEBI in September 2015. Previously, separate legal entities were required for the different businesses. Additionally, SEBI proposed to permit hedge funds to invest in commodity derivatives and said it will soon permit exchanges to offer commodity derivative options.

OTC DERIVATIVES REFORM

Singapore Proposes Changes to Rules for Exchanges and Market Operators

On April 28, the Monetary Authority of Singapore issued a consultation paper to further implement OTC regulatory reform in Singapore. The MAS is seeking comments on draft regulations that affect exchanges and recognized market operators for the trading of OTC derivatives. The draft regulations cover licensing and capital requirements and transitional arrangements. A second consultation paper will be issued by the MAS later in May which will cover changes to product definitions under the Securities and Futures Act and extend the capital markets services licensing regime to OTC derivatives.

LEVERAGE RATIO

HKMA Consults on Implementation Details

On April 13, the Hong Kong Monetary Authority issued a consultation on the implementation of the Basel III leverage ratio framework in Hong Kong. The consultation paper covers several areas including the proposed legislative approach, monitoring, reporting and disclosure requirements, calculation of counterparty credit risk exposures and the proposed timeline to bring the framework into effect from January 2018.