

# **Regulatory Update: A U.S Perspective**

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## **N.B. Required Disclaimer**

**McP's comments and opinions today  
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# Definitions

- **Swaps Dealer**
  - **Asset Class Specific**
- **Major Swaps Participant**
  - **Asset Class Specific**
- **Swap Execution Facility (SEF)**
- **End User Exemption**

# Market Infrastructure

- **G-20 Accord**
- **ICE U.S. Trust and SwapClear Clearing Membership Criteria**
  - **Both have very unique clearing fee structures**
- **Traditional OTC Market Structure**
- **Clearing homogenizes the creditworthiness of all clearing members**

# Market Infrastructure (cont')

- **Dodd-Frank will require that all clearable swaps be traded on Swap Execution Facilities (likely anonymous flat screens) and cleared.**
  - **That is, between Swaps Dealers or Major Swaps Participants**
- **Absent high CCP membership criteria, this would at least create the potential for a Major Swaps Participant to have its trade match opposite a trade of another Major Swaps Participant where the dealer community would otherwise lose its time, place and informational advantage.**

# **Market Infrastructure (cont')**

- **In order for this to actually occur in reality, Major Swaps Participants and Swaps Dealers will both need access to OTC Clearing.**
- **Either**
  - **OTC CCP clearing membership must be changed to assimilate Major Swaps Participants or**
  - **Major Swaps Participants will be forced to utilize current OTC Clearing Members in a client/agency relationship (Chinese Wall implications)**
- **Under either scenario, Major Swaps Participants will be able to trade against any bids or offers on the screen, including those of other Major Swaps Participants.**

# **Market Infrastructure (cont')**

- **Returning to the G-20 Accord .....**
- **Either OTC CCPs need to design an equitable way to assimilate new clearing members that could not otherwise meet the current high clearing membership standards or**
- **G-20 countries will need to pursue other, new OTC clearing initiatives (perhaps like national airlines) or**
- **Non-dealer players will need to accept client/agency clearing relationships or**
- **National authorities may intervene**

# OTC Default Management

- **Why are clearing membership criteria so important**
  - **From the Dealers' perspective**
  - **Surviving clearing members must be able to absorb the portfolio of the defaulter**
  - **Identify, Isolate, Neutralize and Liquidate**
- **Tension between the OTC Default Management Process and the Lincoln Amendment and the Volker Rule**



# End User Perspective

- **Fannie and Freddie**
- **The National Association of Corporate Treasurers has estimated that the average U.S. S&P 500 company would need to hold USD 269 million in collateral against their OTC swaps.**
- **The NACT has estimated that this would likely translate into a loss of 100,000 to 120,000 jobs among S&P 500 companies .**

# **New Futures Commission Merchants**

- **The Lehman Brothers Surprise**
- **Solution: (Part 190 of the Act)**
  - **Section 721(a)(28) of Dodd-Frank will require that any person that accepts collateral from another person to secure, margin or guarantee performance on any futures contract or swap, must register with the CFTC as a Futures Commission Merchant**
  - **Hundreds if not thousands of financial and non-financial institutions will need to register as FCMs.**
  - **Their custodians will need to execute the standard Segregation Acknowledgement Letter.**

# **New Futures Commission Merchants**

- **The requirement to register (not specific to Swap Dealers, Major Swaps Participants or otherwise Exempt End Users) may come as a surprise.**
  - **Implications for the CFTC's requirements for FCMs, including the minimum capital requirements for FCMs , which is driven by the amount of margin accepted.**
  - **Beware of non-functional “name only” FCMs in a bankruptcy proceeding . (Sentinel Management Company).**

# Return on FCM Equity

- **Minimum capital requirement of an FCM is 8% of proprietary margin collateral held plus 8% of client margin held.**
  - **Some well managed FCMs have exited the business in the past 10 years due to a remedial return on equity.**
  - **Non-public estimates of how much collateral it will take to implement financial reform.**
  - **Conservative estimate of the proportion needed just to clear OTC swaps.**

# Return on FCM Equity

- The long term challenges of having an entire innovative industry inextricably wedded to transactionalized revenue model.
- Compare the average tenure of an exchange traded futures contract to the average tenure of an OTC swap
- Estimate the new regulatory capital that it is going to take to support the tidal wave of initial margin for OTC swaps .
- If clearing swaps generates no greater transactionalized revenue than clearing exchange traded futures, calculate your decline in Return on Equity for the foreseeable future.

# Central Bank Services for Systemically Important CCPs

- **Account (s)**
  - **Reserve Rate**
- **Fedwire Funds Transfer Service**
- **National Book-Entry Wire**
  - **Custody**
- **Discount Window**
  - **(only under exigent circumstances)**

# Predictions

- **Material domestic and international regulatory cooperation is actually possible . (Actually not much of a prediction, except I said this last year)**
- **The optimal location, functionality and ownership structure of OTC Trade Repositories will be an iterative process. We may start off with a few too many and then get it right over time. If national authorities either operated OTC Trade Repositories or had unfettered access to the positions, why would they then also need their own large trader reporting systems?**

# Predictions cont'

- Expect a temporary decrease in market liquidity as huge markets shift from voice brokers to flat screens.
- An object at rest will remain at rest unless acted upon by a greater object.
- This will not be without some surprises.
- Unknowns: It is still possible that some regulatory jurisdictions might attempt to encourage specific market segments to migrate there.



# Predictions cont'

- As more and more clearable swaps are cleared and the grandfathered swaps mature, the difference in the information content of the relevant OTC CCP data base and the relevant OTC Swaps Repository becomes marginal.
- Having CCPs paying interest on cash performance bond collateral will profoundly increase the proportion of cash performance bond collateral, system wide, improving the liquidity profiles of CCPs, clearing members and market participants, all.