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Title: **Taming the beast**
Feature: **Feature**
Date: **1 July 2009**

OTC derivatives market participants have known for some time that the days of dealing with nary a regulator in sight were numbered. However, the US Treasury Department recently issued its most concrete regulatory suggestion, even though many of the details at this stage remain unclear. Stewart Eisenhart reports

Even as the hedge fund industry gears up for an expected new push by US regulators to register with the Securities and Exchange Commission (SEC), new rules targeting over-the-counter derivatives markets could have just as significant an impact on how hedge funds and investment managers do business, and which technologies they'll need to do so.

No doubt buy-side firms would like to know exactly how a new regulatory regime for OTC derivatives would affect them operationally, but although more details of what the Obama Administration has in mind have come to light in recent weeks, a fully fleshed-out plan has yet to surface.

Broad sketch, scant detail

The most comprehensive outline to date of the US regulatory framework for OTC derivatives was issued by the US Treasury in mid-June as part of a 90-page white paper, *Financial regulatory reform: A new foundation*.

Arguing for "comprehensive" regulation of credit default swaps (CDSs) and other OTC derivatives, the paper outlines four public policy objectives the Treasury's new rules are designed to address. First is the prevention of OTC derivatives market activities from creating systemic risk. Second is creating greater transparency and efficiency within these markets. Third, regulation should prevent market abuses such as fraud or manipulation, and fourth, regulation should prevent inappropriate marketing of OTC derivatives to "unsophisticated" parties.

To address systemic risk issues, the Treasury would mandate clearing of all "standardised" derivatives instruments through regulated central counterparties (CCPs) required to maintain stronger margin requirements and risk controls. The proposal also raised regulatory capital requirements for more customised derivative trades that do not fall under the central clearing mandate.

To increase market transparency, the Treasury has enabled the SEC and the Commodity Futures Trading Commission to demand new record-keeping and reporting on all OTC derivatives transactions, either through CCPs for standardised instruments or by the reporting of customised transactions to a regulated trade repository.

There are also provisions for moving more standardised components of derivatives transactions to regulated exchanges or electronic trading venues, but details of exactly how these regulations would go into effect have yet to be disclosed, leaving open the questions of how or whether investment managers will have to comply with them.

Initial reactions

Based on what's been proposed so far, buy-side sources caution against prescribing operational or technology adjustments before all details are finalised, but some say a high-level idea of the new regulation's impact can be pieced together

A spokesperson for a Washington, DC-based hedge fund lobbying group who insisted on anonymity for this article expresses general support for the Administration's proposals, but does expect some degree of impact on the group's members in terms of cost. "We're generally supportive of the effort, and our members view it as a positive thing, but there will probably be some additional expense on their part in terms of making sure they have the infrastructure to clear trades that are clearable, and in terms of actually having to report their trades to the extent that those trades are not currently reported," says the source.

"The cost in mitigating risks associated with counterparty trading is something our members would rather pay than have those risks on their books," the source continues, noting that such costs will vary depending on how active individual managers are in derivatives markets, as well as how sophisticated their technology infrastructures are in terms of supporting OTC trading.

"There are still some details to be hammered out - what, for example, do they mean by standardisation?" adds the source. "Whatever final bill is put together will show a more complete picture, but we're happy with what has been presented so far."

Alexander Kouperman, member of hedge fund industry organisation The Hedge Fund Association and president of hedge fund technology service provider InfoHedge, expresses misgivings about too broad a regulatory crackdown on OTC derivatives markets, but does see merit in the widely anticipated centralised clearing component of the Treasury's proposal.

"The best way to achieve more centralised regulation is to create a centralised derivatives clearing venue," Kouperman says. "I think the industry needs this first and foremost to alleviate a lot of the pain and create more transparency, and in fact make oversight and regulation a lot simpler."

Kouperman sees significant short-term effort in order to bring about an effective central clearing mechanism, but those efforts will ultimately result in a better market-place. "It's a tremendous undertaking, but essentially it will bring more efficiency to the market-place and alleviate the huge amount of scrutiny heading towards our community," he argues.

Technology precedent

The less-than-inflammatory reactions expressed by industry advocates to derivatives regulation so far proposed hardly means they don't anticipate any sort of impact upon managers in terms of infrastructure changes. But the main thrust of what regulators have rolled out - central clearing - is an issue managers and their counterparties have already broken ground on for some years. It gets trickier, though, when it comes to allowing investment managers more direct access to clearing platforms heretofore utilised by brokers and banks.

So says Karel Engelen, director and global head of technology solutions at the International Swaps and Derivatives Association, a key participant in negotiations with regulators hashing out new marketplace rules. "The technology direction regarding OTC derivatives is clearly moving towards central counterparties and central clearing, and also towards increased transparency by requiring data repositories to store copies of each of your OTC derivatives trade transactions," Engelen says. "The move towards central clearing and trade repositories is happening already in the industry, but one of the newer developments is the commitment to allow buy-side access to those clearing platforms, and that area will require a lot of technology investment."

Engelen says the Depository Trust & Clearing Corporation (DTCC) already provides clearing services and warehousing for credit derivatives, but typically only very large asset managers have their own connections to its trade information warehouse. If the Obama Administration's final rules require buy-side firms to establish their own connectivity to the DTCC's services, he anticipates most will do so via third-party providers such as Omgeo and T-Zero.

"If you look at how to provide buy-side access to central clearing, more needs to happen, just because clearing ties into processing of OTC trades," he contends. "That process is something funds need to look at to the extent they have trades to clear, and that impacts their risk exposures and margin calls."

Given the shaky economic environment, however, buy-side investments in technologies related to derivatives clearing and access to the DTCC's warehouse will vary, according to Engelen; larger-tier managers with greater exposures to OTC products have been more proactive in this regard than other buy-side sectors.

"The technology investment associated with central clearing of OTC derivatives is something managers are preparing for," he says. "But it hasn't happened yet because the work to allow buy-side access to central clearing is still in the planning phase."

Facilitating an electronic market

Of course, what might spur greater investments in clearing and warehousing-related infrastructures among investment managers is a regulatory mandate to do so. Indeed, new regulation may ultimately push OTC derivatives markets more rapidly in an electronic direction.

Kevin McPartland, senior analyst at financial technology consultancy Tabb Group, sees significant parallels between where some OTC derivatives markets are now and other asset classes - foreign exchange and treasuries - that moved from OTC to electronic environments.

"There's a lot of similarity to draw upon between the forex and treasury markets and where CDSs and interest rate swaps are now," says the analyst, adding that the manner in which other asset types transitioned to electronic trading platforms should prove instructive.

"That's where the CDS market needs to go, not to an exchange structure but to an electronic platform," McPartland argues. "In some respect this market is being built from scratch, so we have the benefit of everything we've learned from equities and options and forex."

Buy-side impact unknown

While buy-side industry sources can more or less piece together a broad idea of how proposed derivatives market regulation could affect buy-side participants, just how directly those rules will affect managers has yet to be made clear, even after the Treasury's latest white paper on the subject.

"It's difficult to anticipate what is going to happen," says Ian Cuillerier, a partner in the structured products and derivatives practice at New York law firm White & Case. "There is likely to be central clearing at some level for some contracts, but we don't know the scope of how that will happen or the scope of how it will be implemented."

Cuillerier adds that technologies already employed by managers enabling nascent participation in centralised clearing platforms will likely pass muster under new regulation, but questions whether buy-side firms will face any additional requirements beyond current trading arrangements for CDS contracts.

"For the most part, what is already there for CDS contracts is between dealers, so the end-users don't get a view of what's happening," he says. "Their world has not really been impacted - they're still facing dealers and doing trades bilaterally.

"So the first step will be figuring out what the model will be for clearing, which contracts will be covered, and then once those issues are addressed we'll move to the secondary step of broadening this effort to end-users, although I'm not sure the regulation will be broadened to end users," Cuillerier continues, noting that in other asset classes end-users typically deal with brokers who are also members of clearing exchanges, eliminating direct involvement.

"At some level, what impact will this have? It's too early to tell whether there will be a direct impact and how trading relationships will go forward." ><

Salient points

- Despite a 90-page white paper outlining its financial industry overhaul plans and recommendations, the US government has yet to provide concrete details regarding new regulations for OTC derivatives markets.

- US Treasury plans to require centralised clearing of more standardised OTC derivative trades hew closely with industry efforts to bring more efficiencies to these markets.

- Industry sources are unclear as to how significantly buy-side and hedge fund managers' operations and infrastructures will be impacted once a new regulatory regime for derivatives is in place.

Source: