Clearing the regulatory hurdles

European trading firms face a year of regulatory indigestion. Key G20 reforms on trade reporting and clearing are set to take effect through the European Market Infrastructure Regulation. Financial benchmarks will be under the microscope and a financial transaction tax is on the horizon.

Regulators have also reached a deal on new rules for Mifid II and the European Securities and Markets Authority will be consulting on the details that will underpin the new rules.

On January 21, Financial News hosted a live webcast sponsored by CME Group to explore how firms are preparing for this wave of regulation. The following is an edited version of that discussion.

The webcast is available to view online by registering at efinancialnews.com/webcasts

Trade reporting deadline looms

SPEED READ

- There has been a greater acceptance of the need to prepare for launch on February 12
- Clients offered delegated reporting options
- Some managers choosing DIY route

DL, Financial News: On February 12, trade reporting will come into effect in Europe. This means that firms will need to report all their over-the-counter and listed trades to repositories or information warehouses. Are your clients ready for trade reporting?

WK, CME Group: In theory, it should be easy to know whether firms are ready by looking at how many of them have Legal Entity Identifiers. Unfortunately, because LEIs are given out by 28 different countries in Europe, as well as the US, it is very difficult to get that number correct.

We think that certain elements of the market are ready, but by no means everyone. Think about this in terms of the number of trades per day that have to be reported: five million futures exchange-traded derivatives transactions, 10,000 to 20,000 of OTC swaps and 250,000 to 500,000 FX forwards. Unfortunately, there is no common mechanism to make those trades look identical. This will create issues in the market, especially with FX forwards, which have limited electronic trading, matching and messaging, and will have to be reported very differently to the exchange-traded derivatives market.

We think that in Europe, about 100,000 entities will have to report. In Germany, for instance, there are about 40,000 but we understand that only 18,000 or 19,000 LEIs have been issued. It is difficult to establish the number in the UK but we know the London Stock Exchange has issued about 3,300.

Over the last few months, we have seen a significant increase in people's acceptance that they need to be ready, but over the next few weeks there is a lot of work to be done.

DL, Financial News: From a buyside perspective, is there a sense that firms are ready?

RM, Investment Management Association: We are not getting members coming to us saying that we have to try to stop reporting happening. I know it does not prove that everybody is ready, but we are getting a sense that, certainly, the bigger participants have been pretty focused on this and that has led to some fairly concentrated thinking about whether or not they want to delegate reporting – and if so, how and on what terms. There are clear signs that just as they are thinking about clearing agreements so they are focused on trade reporting too.

AL, Credit Suisse: From a client perspective, we continue to provide education on reporting requirements. Last month, for example, we had a few hundred clients on a call discussing the topic. We offer what we call Roboc (reporting on behalf of clients). Quite a few clients will delegate their reporting obligations to us and we will report on their behalf.

I think the Financial Conduct Authority will be lenient about Day 1 reporting requirements. If things don't go 100% smoothly, firms will probably be allowed a bit more time to get it right. But I don't believe you can pursue a strategy that involves burying your head in the sand. We hope to be ready and think the marketplace, in general, should be ready.

DL, Financial News: What are the options for delegated reporting? And where does the legal liability lie?

EL, Societe Generale: I would like to highlight that, unlike the Dodd-Frank regulations in the US, the European Market Infrastructure Regulation requires reporting to be two-sided. Until now, it has been one-sided, which effectively means that dealers have been reporting transactions, as opposed to both parties reporting their transaction, which brings into the scope of reporting a range of new actors, who previously had been blithely unconcerned.

I agree that the dealers will, broadly speaking, be ready, which means most transactions will be reported. Does that mean most parties will be reporting? I am not so sure, because the further you go down the chain of infrequently trading entities, the less likely they are to be ready.

Emir allows for delegated reporting. Broadly speaking, there are two commercial offers out there at the moment. One involves dealers offering to report their clients' trades with themselves but not with other trading parties. The other is a more full-service commercial offering, where entities (not necessarily dealers only) offer to report the entirety of a user's transactions.

That still raises the issue of who carries the liability. Emir requires the transactor – the end-party – to be legally responsible for the quality of what is reported,

# of 2014

Participants (l-r): Darren Lazarus, Alex Lenhart, William Knottenbelt, Eric Litvack, Richard Metcalfe and Alex McDonald

Upbeat forecast spells good news for volumes

DL, Financial News: We entered 2014 more optimistically than in previous years. How has that been reflected in trading volumes and activity?

AL, Credit Suisse: From a Credit Suisse perspective, overall we are optimistic. Our outlook for global GDP growth is 3.7% and we think that will surprise markets. US GDP growth is going to be in the region of 3% to 3.25% and even Europe will probably see GDP growth rates of 1% to 1.25%. It is early days, but the signs for equities and bonds are encouraging from a European perspective. In the first three weeks of 2014, European equity volumes were up about 24% on the same time last year.

WK, CME Group: We see a continuation of last year's trend of volumes picking up. We expect outperformance in terms of interest rates to continue in 2014, especially as quantitative easing starts to tail off. It will be interesting, because there is likely to be a lot of volatility in the market, driven by people's response to the numbers. There is no consensus yet about how big the growth will be this year.

EL, Societe Generale: Our outlook is mixed. As William said, we will see the continued tailing off of QE, and that will clearly impact fixed-income markets, combined with an economy that is picking up. Although we think the US Federal Reserve will try to keep rates low, there will be some steepening in the rate curve that will put pressure on bond market investments. We are more positive on equities because we agree the economy is picking up. However, valuations are tight, especially in the US, where it may be difficult to replicate the significant progress we have made in the last year. Europe still has significant inflows, which is helped by a combative policy from the European Central Bank. It is also interesting to look at how primary activity is influencing those inflows. There have been a lot of redemptions in money market funds, as well as inflation-linked and commodities funds, which, to a certain degree, is flowing back into growth-oriented markets.

RM, Investment Management Association: I agree that there is increased confidence in equities. And it's very significant. One certainly has the impression that many investors had been prepared to sit on the sidelines, so the most significant move may be from cash into equities. Clearly, there will be some risks, particularly on the interest rate side, but the increase in confidence comes after a long period of watching, waiting and wondering where it is safe to invest.

AM, Wholesale Market Brokers' Association: I think there will be some dispersion in the fixed-income and currency markets, with the US and the Anglo-Saxon economies growing and looking to raise interest rates, whereas in Europe, deflation is still the main focus.

Meanwhile, emerging markets will also see more dispersion, with some of the key emerging market economies of China and India slowing a little. That will probably lead to a mixed outlook for the commodities markets, because demand for commodities comes chiefly from those countries.

DL, Financial News: Tapering is the big looming event of the year, in many ways. We know it is happening, but not necessarily when and how. What impact will it have on trading firms?

EL, Societe Generale: I think we have a good sense of when it is happening. The Fed has been at great pains to telegraph its movements well in advance. We have to remember that it has been buying $85 billion of Treasury bonds and mortgage-backed securities every month, which is an extraordinary injection of cash into the market on a regular basis. It wants to disengage in the least disruptive way.

You also have to look at tightening [raising interest rates]. The Fed has been explicit that it wants to keep interest rates at, or near, zero significantly beyond the time when unemployment falls below 6.5%. This is likely to start being a reality in a year's time or maybe sooner. I think the Fed will be accommodating in terms of holding rates down.

The panel

Darren Lazarus
Executive editor, special reports,
Financial News

Alex Lenhart
European head of listed derivatives and OTC clearing,
Credit Suisse

William Knottenbelt
Managing director, Emea,
CME Group

Eric Litvack
Head of regulatory strategy, global banking and investor solutions,
Societe Generale

Richard Metcalfe
Director, regulatory affairs – institutional and capital markets,
Investment Management Association

Alex McDonald
Chief executive,
Wholesale Market Brokers' Association

and that is not something you can readily transfer. It is not something that banks, dealers and other reporting entities are keen to take on because, in most cases, there is not a compelling commercial logic to offering reporting.

The International Swaps and Derivatives Association recently published a standardised reporting contract which clearly lays out the view that, ultimately, liability belongs to the client, while the dealer or other reporting party is liable for negligence.

DL, Financial News: Does that mean some clients are prioritised over others? Are bigger firms that trade regularly offered delegated trading but not the smaller ones that maybe only trade a few times a year?

EL, Societe Generale: It is not evident, because the bigger firms may actually have an incentive to develop their own reporting.

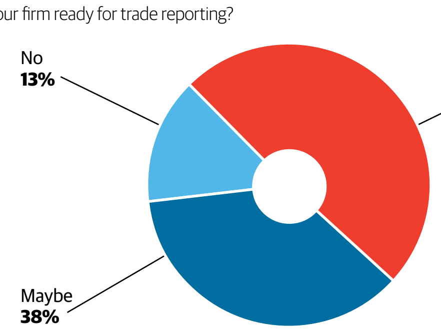
WK, CME Group: Some of the larger asset managers have taken on that role themselves. The smaller entities are one of the reasons we came up with delegated reporting. We can do it for the transactions we are in control of, but we will also take all other transactions.

RM, Investment Management Association: From the IMA's perspective, we are seeing that some people are going down the do-it-yourself route. Part of the consideration is the fact that you do not just report the trade – there are continuing reporting requirements. In gathering that sort of information on valuations and collateral, it may actually make sense for some firms to cut out the middleman.

We probably all hope that, from the regulators' point of view, this is going to be about proportionality, because the whole point about trade repositories is to pick up systemic concentrations of risk.

How prepared are you?

Is your firm ready for trade reporting?



What happens when firms are not ready?

DL, Financial News: What will the regulators do when a firm isn't ready for trade reporting? What is the worst that can happen? Will we see people move out of the market out of fear that they are not properly set up?

WK, CME Group: It is going to be interesting. In the US, we have the advantage of first-hand experience. When regulations on swaps clearing came in, we initially saw the volume of OTC transactions drop off, and then as people became comfortable with the concept, it picked up again.

EL, Societe Generale: Surely, the two-sided nature of the reporting makes a difference? In the US, there was certainly a blip in traded volumes, but that quickly re-established itself, primarily as dealer firms got their infrastructure into place. In Europe, you are talking about end-users who have to face up to potential liability and that is something that they will be concerned about. I agree it will re-establish itself over time, but I think the blip might last longer.

RM, Investment Management Association: In the world of OTC derivatives, the rate of growth has dropped dramatically, according to the most recent survey in 2013. I think the dollar OTC derivatives market went down in terms of daily average by a couple of per cent between 2010 and 2013, which is unprecedented in the history of OTC derivatives.

AM, Wholesale Market Brokers' Association: The Financial Conduct Authority has been very explicit that as long as it sees an intent to move down the road of trade reporting and the speed of that movement will be proportionate to the ability of the entity to comply, then it will be happy. The worst that could really happen is that the FCA will threaten to remove authorisation to deal in the markets. I don't think it needs to jump quickly into a world of fines and a world of persecution. That can come afterwards, but they can certainly threaten to deauthorise if firms are not showing a willingness to start trade reporting.

Although the other issue, and an issue for our members, is that many participants in wholesale markets are not European entities, and therefore are not in the scope of Emir, it may well be that only one side ends up reporting, because the other side is not a European entity. In the wholesale markets, Emir's trade reporting requirements have been less of an issue because the bigger entities have moved quicker and are in a position to report.

EL, Societe Generale: I, too, think there will be a pragmatic response by the regulators on reporting. There will be a period of time when firms will be able to demonstrate progress to the regulator, as long as that progress is clearly visible. Over time, that pragmatic approach will become much more aggressive and I don't believe it will be many months before all firms will need to meet their reporting requirements.

DL, Financial News: If parts of the industry do not provide the correct data to the regulators, how long will it take to get to the stage where the data is useful and they can actually spot systemic risk?

AM, Wholesale Market Brokers' Association: I think we are talking in the longer term but you have to start somewhere in order to get to a position where the systemic risk can be analysed.

Knottenbelt: US has the benefit of first-hand experience


Lenhart: complex FTT could jeopardise Emir implementation

Industry awaits clarity on FTT

DL, Financial News: This month, the European Council will further discuss implementation of the financial transaction tax. Will it happen this year, and what will the FTT look like?

AM, Wholesale Market Brokers' Association: We will get some clarity in the coming weeks, because it was a key issue in the German election. I think there will be some sort of stamp tax-plus, similar to what exists in the UK. It will, therefore, be based more on residency than issuance. At that point, Europe will say "okay" and move on.

RM, Investment Management Association: We are certainly taking seriously the renewed moves to push the FTT along. It is intriguing that there is a Franco-German summit on the issue scheduled on the day after the European Council meeting.

EL, Societe Generale: I would not put too much emphasis on the Council meeting at this stage. The FTT is on the agenda of the Greek presidency, and Greece is part of the 11 EU countries participating in the project, but the presidency is not in a position to drive the proposal. The Franco-German ministerial meeting will be more interesting.

DL, Financial News: Do you believe it will happen in 2014?

EL, Societe Generale: I don't think there will be an FTT in 2014 and it may be wider than just an equity stamp tax because there is a desire to pull in something wider, possibly including derivatives, because they are the great evil. If France and Germany, and possibly Italy and Spain, can agree on a framework, the question is whether they can bring along all the smaller countries – like Slovakia, Slovenia, Greece, Belgium – which have different incentives to participate in that process.

WK, CME Group: One of the issues is the extra-territorial application: if you are a European bank trading in the US, does FTT apply? In the case of France, we've seen that the amount of money the country has generated from its existing transaction tax has not been nearly as much as expected because of exclusions. Do the clearing houses and the exchange in that jurisdiction also benefit from the tax? If not, it could harm the entity, which brings us back to the question of exclusions.

RM, Investment Management Association: What does it do to the growth agenda emerging in European politics? Investors will end up paying most of this.

DL, Financial News: That was mentioned right at the beginning and the UK used that argument, but it did not seem to get very far.

RM, Investment Management Association: It is a fact, all the same.

AL, Credit Suisse: Given the operational workload that most dealer communities face with the implementation of Emir this year and next, it would be very difficult if the FTT were to come in too. Stamp duty equivalents would be a sensible way to implement a transaction tax. A complex tax would place a burden on the marketplace and could jeopardise Emir implementation, which I don't think would be in the interests of the politicians in Europe.

Firms face clearing conundrum

SPEED READ

- Dealers face significant work to get ready for OTC clearing
- Flows could switch to futures-like products
- Emir requirements for segregated accounts are complex

DL, Financial News: The European Market Infrastructure Regulation will require the mandatory clearing of standardised OTC derivatives by the end of the year. What are the key operational challenges that firms will need to be aware of?

AL, Credit Suisse: From a Credit Suisse perspective, we are in the fortunate position to have learned some lessons from central clearing in the US. Operationally, the biggest hurdle we face is ensuring that we have the links to the exchanges, the underlying clients and, where necessary, the custodians. There is a significant amount of work being done by most dealers to ensure operational readiness by the time OTC clearing under Emir becomes a reality, which we think is probably Q4 2014. We can learn from the US, but there are some idiosyncratic issues in Europe that need to be solved.

Clients, in our experience, broadly fall into two buckets. One segment of clients is very keen to engage with dealers to ensure that OTC clearing readiness is achieved ahead of time and, indeed, many test trades are already happening. Other clients only want to engage in OTC clearing when they have to; until then they are transacting on a bilateral basis. That could potentially be quite dangerous as clients rush through a very narrow door with only a limited number of providers.

DL, Financial News: Could this affect flows? Will firms pull back until they have a better sense of what is happening?

AL, Credit Suisse: There is a real risk that if a firm has no OTC clearing capabilities, its only choice will be to opt for an asset class that does not have that requirement, such as a futures-like contract.

DL, Financial News: Clearing houses will need to offer segregated accounts to protect fund managers' assets. Does that require specific requirements to know what they want?

WK, CME Group: We have tried to create a series of capabilities, ranging from the omnibus option to segregated accounts, and it is up to clients to choose how far along that curve they want to go. Obviously, total segregation is more expensive than the omnibus model, and even within client groups it will depend on their clients as to what level they need. There is quite a lot of work that needs to be done to set up the full segregation account, but even the omnibus account offers some segregation.

DL, Financial News: When people go to different clearing houses, there might be different models for segregated accounts. Are fund managers asking for standardisation? If so, is it a pipe dream?

WK, CME Group: We have been discussing standardisation for at


McDonald: 'Ice will help rebuild confidence in the figures'

Adapting to benchmark

DL, Financial News: With the Libor and FX scandals in 2013, there will be a push in 2014 to rebuild confidence in key benchmarks that underpin the derivatives industry. Will the handover from the old administrator of Libor, the British Bankers' Association, to the Intercontinental-Exchange on February 1 bring wider changes to the benchmark industry? How will it impact on trading firms?

AM, Wholesale Market Brokers' Association: Ice said it wants to ensure Libor rates are validated by the underlying trades, which will naturally produce more confidence in the numbers. Ice has also installed two high-ranking individuals as the heads of the Governance Board and the Supervisory Board, respectively. Conversely, floating-rate notes in the US are not using the Libor benchmark anymore, instead looking at an average of Treasury bill yields – in other words, the market itself and traded prices.

DL, Financial News: The European Union has taken quite a broad view or interpretation of a benchmark. What should a benchmark be?

RM, Investment Management Association: It is reasonable to go over anything, which a big market is sensitive to, and that was the direction they were trying to go in. But the original proposal, on which there has been some pushback from the European Parliament, did end up being too broad. You end up capturing things like performance benchmarks,

Setting the standard: the market is coming closer together over clearing, but there is still work to be done

least two years, if not longer. And through advice from the European Securities and Markets Authority and various other formats, the market is coming closer together, but we're not there yet.

AL, Credit Suisse: I would certainly agree. We fully understand that central counterparties want to compete with other CCPs for market share and one of the ways in which to do so is through individual segregation.

From the dealer perspective, standardisation is a fine development. However, the Emir requirements around individual segregation are operationally complex. We see it as first saying that "we want to ensure that we are in a position to offer the most simplistic, generic version of individual segregation by exchange of the underlying client".

When clients demand additional security over time, we can make additional forms of segregation available to them.

DL, Financial News: How ready are interdealer brokers for clearing?

AM, Wholesale Market Brokers' Association: They are very much embracing it and were doing so long before Emir was even dreamt up. The dealer community has demanded clearing – particularly for interest rate derivative products, which are capital intensive – because it enables the balance sheet to be more efficiently used.

In the early days of discussions on Emir, the interdealer brokers were all getting their connectivity to the range of CCPs in place by hiring middleware providers, thus ensuring that they were not restricted to only one or two CCPs.

The developments recently have been the reverse of that connectivity, in that the clearing status of members is broadcast back to the venues to ensure that the prices they advertise are accepted by clearing houses. The debate over the certainty of execution, both here and in the US, has been about how to ensure that a trade will be taken up and cleared, and that there is no operational risk.

One recent issue, for example, has been the demand for 24-hour clearing. All CCPs hope to be open 24 hours a day by the end of the year.

Harmonisation and the unintended consequences of regulation

DL, Financial News: How will the new rules affect the competitive landscape? Will the clearing rules, for example, mean more firms enter the market or will it lead to consolidation?

EL, Societe Generale: As with Markets in Financial Instruments Directive I, you will see a whole raft of new initiatives coming out. It happened in the US, where clearing regulation resulted in the creation of swap execution facilities [regulated platforms for derivatives trading]. I don't think they will all be commercially successful. Ultimately, at the same time as raising barriers to entry, new regulations also create new opportunities. I suspect that you will fairly quickly see a re-concentration around a small number of actors, including existing but also new ones. Somebody out there may well build a better mousetrap, but there are not going to be 500 new mousetraps.

Litvack: new regulations raise barriers but they also create opportunities

DL, Financial News: Some clearing houses are considering setting up swap execution facilities, and so are interdealer brokers. Is there a blurring of the lines, where people who previously worked alongside each other are now competing against each other?

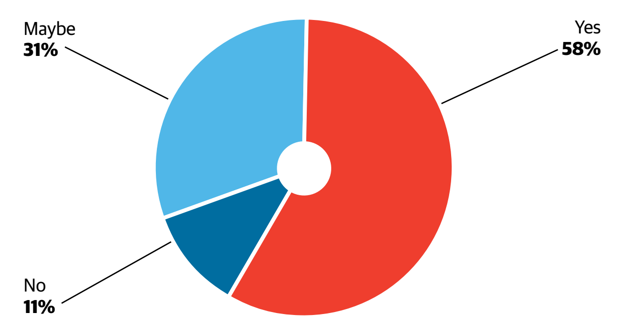
WK, CME Group: There are different reasons for setting up a Sef. If you have a capability that allows you to compress pricing and orders, you need a Sef. Clearing houses may have very different reasons from interdealer brokers or banks for having a Sef.

DL, Financial News: Is there a risk that, due to different regulatory regimes, a firm might want to avoid a counterparty because they are based in the US?

RM, Investment Management Association: Yes. We saw it happen relatively early. When our members realised how easy it was to fall into the Dodd-Frank regime, some took swift action to avoid it, even if it wasn't conducive to the business. It is here to stay.

Cross-border rules

Are cross-border rules making you reconsider where to book trades?



Source: Financial News webinar poll

changes

rather than transactional ones, which is, arguably, really not necessary. If you look at the issues around Libor or Euribor, those clearly needed addressing, possibly over and above the Market Abuse Directive. But to sweep everything in is creating more of a problem, because you will just dilute resources away from the issues you need to be focusing on.

DL, Financial News: **Should banks be forced to submit trading data?**

AM, Wholesale Market Brokers' Association: **Once you compel people to do something, you are not measuring what they choose to do – you are measuring their compliance objective, which brings you back to looking for more transparency on traded prices.**

Metcalfe: 'We are still debating the finer points of recovery and resolution, not least in relation to CCPs'

Regulation: good, bad or just more costly?

DL, Financial News: With all the various regulatory initiatives, have we come to a stage where we are in a safer place or is it just more costly?

AL, Credit Suisse: Certainly, more costly; the future will tell whether we are in a safer place.

WK, CME Group: It has brought a lot more clarity to the market. So, in that respect, it has served some purpose.

EL, Societe Generale: I would say marginally safer, but not remarkably so. A risk is like a balloon filled with water. You push it in on one side and it pops out the other side.

RM, Investment Management Association: We are still debating the finer points of recovery and resolution, not least in relation to central counterparties. We have to get that over and done with before we begin to draw conclusions.

AM, Wholesale Market Brokers' Association: We have made the landscape less competitive, albeit that we are encouraging a reverse of the Big Bang and more specialisations in certain areas of the financial field, which was, perhaps, one of the unsaid agendas. But, yes, it is resolution and recovery of our big financial infrastructures which is the key thing, and that is yet to be addressed.