The New Clearing Landscape in the U.S., U.K., and Europe—What Will it Look Like?

Central counterparty clearinghouses (CCPs) are increasingly viewed as bulwarks of financial systemic stability. Financial reform in the U.S., U.K., and Europe is mandating CCP clearing for standardized over-the-counter (OTC) derivatives. This process will require careful balancing by regulators because CCP clearing does not simply eliminate risk—it may shift or concentrate risk, or generate new risks. End users of swaps, as well as brokers and dealers, will experience new risks and costs. Meanwhile, tensions between systemic stability and competition remain unresolved and will battle for primacy in the evolution of CCP clearing for OTC derivatives.

JEFF BANDMAN

The highest priority of financial reform is achieving financial systemic stability through improving market structure and supervision. Regulatory reform is focusing extraordinary attention on clearing firms and activities. There is broad consensus that the central counterparty clearing (CCP) model\(^1\) functioned well and with great resilience to bolster systemic stability during the crisis, and that CCPs are institutions of systemic importance in the financial market structure. There is also consensus that standardized over-the-counter (OTC) derivatives should be cleared through CCP clearing wherever possible.\(^2\)

Despite this consensus, there are unsettled and highly contested issues related to such fundamental CCP matters as ownership, governance, membership, competition, end-user exemptions, end-user participation, risk allocation, permitted collateral, permitted investments, and product eligibility. While these subjects are all addressed in the legislation enacted in the U.S. (the Dodd-Frank Act\(^3\)) and proposed in the E.U., their resolution depends largely on the outcome of rulemaking that is just commencing in the U.S., and perhaps a year from starting in the E.U. Powerful underlying tensions between systemic stability and competition will battle for primacy in this process. In addition, new laws and regulations targeting cleared OTC derivatives—and the principles embedded therein—may over time have important

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\(^1\) In the CCP model, a clearinghouse sits in the middle of a trade, assuming the counterparty risk when two parties (or members) trade, and operates a clearing system. When the trade is accepted by the CCP, it becomes the legal counterparty to the trade (through novation) for both parties, becoming the buyer to every seller and the seller to every buyer, thus ensuring performance. If one party fails, the CCP steps in. By assuming this counterparty risk, the CCP underpins many important financial markets, facilitating trading and increasing confidence within the market.

\(^2\) In September 2009, G20 Leaders in Pittsburgh agreed that: “All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.” See “Leaders’ Statement: The Pittsburgh Summit,” clause 13 (Sept. 24–25, 2009), available at http://www.pittsburghsummit.gov/mediacenter/129639.htm.

consequences for cleared listed derivative products and the CCPs that clear them.

This article is divided into three principal sections: first, a discussion of key issues and tensions in clearing in the U.S., U.K. and E.U.; second, data regarding the size of the OTC derivatives market, clearing activity for OTC interest rate and credit default swaps, and CCP initiatives for OTC derivatives; and third, a discussion of the status of regulatory reform in the U.S., the U.K., and the E.U. as it relates to clearing.

KEY ISSUES IN GLOBAL CLEARING

Too Big to Fail: Systemic Stability vs. Competition and Innovation. CCPs are now entities that are “too big to fail.” Systemic stability is clearly the major priority of financial reform. Promoting competition, while still important, is necessarily secondary. The new importance of CCPs to systemic stability will have ramifications for regulatory choices affecting CCP ownership, governance, conflicts of interest, open access for members and products, permitted collateral, use of collateral, and a host of other issues. It seems logical to expect that ties will be broken in favor of systemic stability. Regulators are clearly mandated to ensure that CCPs mitigate systemic risk rather than introduce or aggregate it.

The stakes for regulators—and for systemic stability—are magnified because under the new regime, risks that were previously dispersed throughout the system are now to be more greatly concentrated in CCPs. This concentration may intensify if individual CCPs achieve dominant market share for entire classes of centrally cleared OTC derivatives (and/or correlated listed products). The new terminology for CCPs in the Dodd-Frank Act—calling them “utilities”—invites thoughts of regulated monopolies, non-competitive markets. The emphasis on CCPs to underpin systemic stability and apply strict risk management standards has already resulted in complaints that competition is burdened or reduced.

The Challenge for Clearing Regulation: How Not to Increase Systemic Risk. In overseeing CCP clearing of swaps, regulators will need to determine how not to create a degree of systemic risk greater than what would exist if bilateral swaps were not centrally cleared or listed. While it seems intuitive that higher collateral requirements and strict guidelines on how CCPs can invest collateral are safer for systemic stability, these requirements and guidelines, especially in combination, could paradoxically result in systemic harm by creating scarcity of permitted collateral. Bank capital requirements will already be higher under Basel III. New higher collateral requirements associated with OTC swaps, and the extension of collateral requirements to additional market participants, will further increase demand for highly liquid collateral.

The full systemic impact of the new collateral requirements will also depend on what collateral requirement the U.S. and E.U. will apply to non-financial end users. The greater (and more pervasive) the collateral requirements, the greater demand for qualifying collateral there will be.

These collateral requirements may further challenge systemic stability by exposing each client of a clearing member to indirect counterparty risk exposure to the other clients of that clearing member, while at the same time increasing the magnitude of this risk by mandating increased CCP clearing of OTC swaps. If one or more of those other clients defaults, the clearing member could default as well.

4 The major OTC derivatives categories include equity, credit, interest rate, commodities, and foreign exchange (FX). Major exchange-listed CCP-cleared derivatives products categories include financial futures and options, energy and commodity futures and options.


6 Initial and variation margin (or collateral) is collected from clearing members; should they fail, this margin is used to fulfill their obligations. (A CCP typically has access to other funds as well, which may include a default fund, its own capital, lines of credit, insurance policies, and now access to central bank lending windows.) The amount of margin and collateral is set by the CCP, which assesses member positions and market risk during (or more frequently).

7 Posting collateral is not limited to CCP-cleared swaps; it also may take place bilaterally between swaps counterparties. CCPs are generally viewed as utilizing collateral more efficiently due to the greater pool of counterparties and positions that may be cleared. The greater pool of counterparties and positions that may be cleared. The greater pool of counterparties and positions that may be cleared.
jeopardizing the original client’s collateral with the clearing member. Clients have little visibility into the risk exposure of their clearing firms to other clients. This scenario helps illustrate that CCPs do not, contrary to belief, automatically eliminate counterparty risk from the system. To combat such risks, the E.U. has proposed important new requirements that would enable clients to elect to segregate their funds rather than allowing the clearing member to hold them in an omnibus account. U.S. regulators may follow a similar path.

Systemic issues also arise in determining what CCPs do with collateral once they have it. A number of institutions have expressed concern about removing considerable liquidity, especially highly liquid instruments, from the system, thus creating a shortage of acceptable collateral and cash, leading to an increase in repo, a reduction of hedging, or both, while increasing costs. Due to such concerns, the E.U. decided against requiring CCPs to deposit their collateral at central banks, and will permit CCP deposits at commercial banks.

In addition, mandatory central clearing may increase systemic risk if a swaps product that is simple enough to be cleared is used in the market to offset a product too complex to be cleared. If the simpler product must be cleared but the more complex product is not, the opportunity to reduce volatility is removed from the bilateral OTC market, and the amount of systemic risk may increase. Yet forcing the more complex swap into CCP clearing is self-evidently not a viable option. For swaps end-users, there may be increased legal and operational risks, as well as diminished returns and greater costs, in maintaining a dual collateral structure with both CCP-cleared and bilaterally cleared swaps.

Swaps end-users may therefore seek out trading strategies utilizing products not subject to collateral requirements, either due to the increased collateral costs for swaps (whether CCP- or bilaterally cleared), diminished returns due to such increased costs or scarcity of permitted collateral, increased legal and operational risk, increased counterparty risk (to clients of clearing members), or for other reasons. Such a flight from swaps could result in decreased system stability, decreased market efficiency, or decreased visibility of systemic risk.

Another dilemma for regulators arises if only one side of a trade clears through a CCP, or CCPs are otherwise exposed to unidirectional exposure and in a difficult position to manage counterparty risk against significant market movements.

User Ownership, Governance, and Conflicts of Interest. CCPs are currently owned and operated by user-members, or by exchanges or other execution facilities. Both types of ownership structure give rise to conflict of interest and governance concerns under review by legislators and regulators. U.S. regulators have expressed special concern that conflicts may influence CCP decisions on whether to clear particular contracts, and on what criteria should be required for CCP membership (as well as fairly applying those membership criteria).

CCP members supply the bulk of the capital at risk in CCPs via their contributions to default funds, and initial and variable margin; they also supply product expertise in risk characteristics. When CCP members exercise governance rights, how can regulators ensure that decisions are truly being made for risk-management reasons rather than anti-competitive reasons? If, however, their governance rights are restricted (along with their risk management and product expertise), systemic stability could be at greater risk. Moral hazard also may come into play—if members’ governance rights are limited to give their clients greater say, clients could drive decisions for which they do not bear the full economic or reputational risk.

Ownership restrictions, voting and governance mechanisms, and regulation of CCP behavior are all potential tools for addressing conflicts. The U.S. and the E.U. are taking somewhat different paths. The E.U. Proposal defers to existing ownership models, and instead sets forth transparent governance and open access requirements for all CCPs. The E.U. Proposal does not give clients any governance rights, but provides that CCPs must set up adequate channels for consultation in risk committee matters.

Congress mandated U.S. regulators to focus closely on CCP ownership (particularly by major swaps

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8 Oslo Clearing, EC Public Consultation on Derivatives and Market Infrastructures (July 9, 2010) [hereinafter “Comment Letter”]; NYSE Euronext, Comment Letter, at 10; RBS, Comment Letter, at 24; LSE Group, Comment Letter, at 24; Black Rock, Comment Letter, at 2; Cardano, Comment Letter, at 2-3.

9 HSBC, EC Public Consultation on Derivatives and Market Infrastructures. HSBC Response (2010), at 2 [hereinafter HSBC E.U. Letter]. Swaps that do not clear through a CCP are typically subject to bilateral credit or clearing arrangements between the counterparties.
dealers or banks) and governance issues and their impact on competition. The CFTC has proposed conflicts of interest rules that would extend to ownership as well as governance. These rules would limit individual ownership (or voting power) by CCP members to no more than 20 percent, and also introduce an aggregate ownership (or voting power) limit for “Enumerated Entities”\(^{13}\) (such as banks and swaps dealers) of 40 percent. It is unclear who (other than exchanges or swap execution facilities (SEFs)) might realistically be expected to own the other 60 percent, since most CCP members are, or are affiliated with, Enumerated Entities. An alternative permitted ownership structure would limit any member or Enumerated Entity to a maximum of 5 percent ownership or voting interest, with no aggregate limit (this is essentially the ownership structure of CLEARNET Ltd. (LCI)). The proposed CFTC rules also introduce requirements for CCP independent directors, who will also have specified powers and participation on nominating and risk management committees.

**Membership Qualifications for CCP Users.** There is broad agreement in favor of granting access to clearing for as many products and transactions as can be cleared with proper risk management. Access may come as a member of a CCP, or via indirect access as a client of a member. Underpinning this debate is a concern by some stakeholders that large swap dealers are trying to perpetuate their franchise on OTC swaps in the new centrally cleared swap world by imposing unreasonable restrictions on eligibility to be a clearing member in the swaps CCPs, cladding in the guise of risk management. Others suggest that, because the size of the trading market for swaps ($40-$60 billion) is so much larger than the clearing market ($300-$500 million), the discussion regarding clearing is a proxy for the battle over trading.\(^{14}\)

Membership qualifications for OTC derivatives CCPs will require regulators to balance risk management, competition, and other considerations. Membership criteria, while established by each CCP, will be subject to regulatory oversight for prudence, fairness, and compliance with required governance procedures.

Large swaps dealers and dealer-owned CCPs have contended that both capital and market expertise are critical because CCPs are going to be the ultimate repository for risk that was previously dispersed throughout the market. Proper risk management, and provision for the absorption of risk, is central to systemic stability. Arguably, the opposite of too big to fail is too small to survive.

In the event of a significant member failure or default involving CCP-cleared OTC derivatives products, two things would occur:

- First, the CCP draws on the capital necessary to stabilize itself (which ideally will come from the defaulting firm’s margin or default fund contribution, but may come from the default fund provided by other members).
- Second, the remaining members may need to take on, and trade out of, the defaulting member’s positions at minimal financial loss.

The second step requires great expertise in trading within the relevant product. In a “typical” default scenario involving more liquid exchange-traded products, this step would not be necessary, as the CCP can liquidate the defaulting member’s positions itself in the open market of the transparent and liquid exchange. The need for trading market expertise may be magnified, however, where (1) the products may be more complex and less liquid or fungible than other CCP-cleared products, and (2) a single product likely trades on multiple venues (in contrast to a listed derivative product that clears on a single exchange).\(^{15}\)

The Swaps and Derivatives Market Association (SDMA) argues that expanding the membership by including smaller players would reduce the “too big to fail” and “too interconnected to fail” risks, and thus diversify risk, increase competition, and reduce concentration. They cite statistics that 96 percent of the swap market still goes through the top 10 swaps dealers. They propose that smaller firms be allowed to become direct members of the CCPs that clear OTC swaps, subject to “progressive capital requirements” such that they put up less capital, and are limited proportionately in the amount of risk they can put through the system.\(^{17}\) Even if a smaller member defaults, the impact on systemic stability would...
be minor compared to the impact if a large dealer defaults in a more concentrated market.\textsuperscript{18}

The SDMA and others suggest that the “market expertise” requirement is a Catch-22 to preclude firms that do not already clear substantial amounts of swaps from joining those that do, and could be addressed through progressive capital requirements or joint ventures. In addition, less “expertise” should be needed due to market reforms resulting in more transparent pricing and a more liquid and standardized market for most CCP-cleaned OTC swaps.

Ownership Restrictions. While the U.S. proposes to impose ownership restrictions and the E.U. expressly does not, marketplace views are varied. At one end of the spectrum are those who oppose any restriction on ownership by market participants or exchanges, and believe that any systemic issues can be resolved through regulatory enhancements to governance. These include NYSE LIFFE, the Committee on Capital Markets Regulation, and MarketAxess, which also points out that capital from market participants will be needed to help the market realize the improvements reform is trying to achieve.\textsuperscript{19}

Others, such as LCH and JPMorgan, have not opposed ownership restrictions but consider them of far less importance than voting and governance. Still others, such as TradeWeb, have pointed out that, at least in their early stages, many important market structure innovations have been born with a small number of market participant owners, and there should continue to be leeway for such innovation to develop.\textsuperscript{20} CFTC commissioner Jill E. Sommers expressed strong concern that ownership restrictions would inhibit emerging CCP competition in her dissent from the CFTC Conflicts Rules Proposal.\textsuperscript{21}

Meanwhile, the SDMA and the AFL-CIO believe that ownership restrictions are essential, and that addressing governance alone will fall short. They claim, for example, that the consortium of nine swaps dealers that takes 50 percent of the profits in ICE Trust US (the leading CCP for OTC CDS swaps) cannot truly be independent, and provides those same dealers with an exclusionary mechanism.\textsuperscript{22}

Improved Governance Mechanisms. Improved transparency will include both “before-the-fact” transparency of what the decision-making process is, who participates, and what principles are applied in, and “after-the-fact” disclosure of what was decided and why.

Independent directors have been proposed in the U.S. and E.U. Those who believe that ownership needs to be restricted are skeptical of how “independent” such directors can be, the process by which they are chosen, the parameters for measuring independence, and their ability to stand up to insiders. Others emphasize the need for expertise, and note that the public companies that succumbed to the financial crisis had independent directors who lacked sufficient expertise to recognize the true risk exposure their firms had. It has been suggested that it is difficult to find risk management expertise independent of the CCP members who are the largest market participants.\textsuperscript{23}

The E.U. Proposal requires one-third of CCP directors to be independent, with a minimum of two independent directors. End users and clients of CCP members are not given a mandatory seat on CCP boards, nor are they given mandatory presence on the CCP risk committee. The CFTC proposal likewise requires 35 percent of CCP members to be independent, with a minimum of two independent directors with appropriate expertise. The CFTC further prescribes powerful roles for these independent directors on the CCP’s risk committee and nominating committees.

CCP Ownership by Exchanges. Exchange ownership of CCPs, particularly in financial futures, has come under scrutiny for anticompetitive effects. In 2007 the U.S. Justice Department concluded that the Chicago Mercantile Exchange/Chicago Board of Trade’s (CME/CBOT) control over its CCP had created barriers to competition against CME/CBOT’s financial futures products.\textsuperscript{24}

The key issues are the CCP’s control over margin offsets, contract fungibility, and open interest migration. The ability to offset correlated positions (margin offsets) reduces the capital required to trade, and the ability to trade fungible contracts (contract fungibility) lowers capital requirements for trading. The CFTC concluded that CME/CBOT’s control could create significant barriers to entry for exchanges competing with CME/CBOT for CCP membership and for entry into financial futures markets.
contracts is not merely flat (through margin offsets) but that the trader has effectively closed its positions. Under the CME/CBOT CCP rules, a competing product traded on another exchange is not eligible for subscription to the exchange-controlled CCP, and therefore not eligible for margin offsets, netting, or contract fungibility. The practical impact of this lack of eligibility is increased cost to the customer of holding positions on two exchanges and posting (and managing) margin for those positions. This makes it very difficult for other exchanges to launch competing products. European competition authorities looking at potential European exchange combinations have reached similar conclusions. In addition, efforts to migrate open interest to another exchange and CCP through block trades have been blocked as “fictitious” trades under the incumbent exchange’s rules.

By contrast, in the U.S. equity options market, all major equity options exchanges clear through OCC (Options Clearing Corporation), so that a customer can buy 100 options on one exchange, sell the same 100 options on a different exchange, and be flat in his positions as a result.

Full fungible access to an incumbent exchange’s clearing services is thus extremely helpful, and perhaps critical, for a new or existing exchange to compete in trade execution of competitive contracts. It seems reasonable to expect a truly independent CCP would welcome qualified contracts from multiple, competing venues. ICE Trust and Morgan Stanley point out that there is already competition among multiple CCPs to clear every meaningful OTC swap product, and that there is ample financial incentive for CCPs to clear any reasonably clearable swap product.

To date, U.S. regulators have not taken action to separate CME/CBOT from its CCP. The Dodd-Frank Act, while expressing support for “non-discriminatory access,” does not currently go that far—in fact it expressly exempts certain categories of instruments cleared within the CME/CBOT CCP vertical. If CME/CBOT were forcibly divested of its CCP, it would be at a significant disadvantage compared to European financial futures exchanges that control their CCPs, notably LIFFE and Eurex. It seems unlikely that U.S. regulators would take such a step unless European regulators took similar action with LIFFE and Eurex. Likewise, it seems unlikely the E.U. would force Eurex or LIFFE to divest unless the CME were to do so.

Over the long term, it is possible to imagine that regulators and central banks will in fact force the decoupling of these businesses. This will be due to the cumulative effect of viewing and treating CCPs as utilities with systemic importance, greater regulatory supervision of CCP access and operations, the desire for greater competition (among transaction venues and among CCPs) once regulators get more comfortable regarding both systemic stability and their new responsibilities for CCPs, and ultimately full implementation of the principles and mechanisms surrounding conflicts of interest, voting and governance, and non-discriminatory access.

In the short term, the status quo is likely to remain. The exchange-owned CCPs performed well during the crisis, and the first focus of financial reform is to fix what is perceived as broken.

**Competition Between CCPs.** Regulatory actions and rulings will frame the competition between CCPs. On what basis will CCPs be allowed to compete against each other? If one agrees to clear a product and another does not, does that entail a “race to the bottom” or just that one has better risk management capabilities or other systems or capital structure in place? Two CCPs could provide the same clearing service at lower costs than the incumbent CCPs. If allowed to compete, the benefits to the industry are obvious:

- New CCPs can improve efficiency and drive costs lower
- More competition means better outcomes for clearing members
- Competition can improve oversight and lower systemic risk
listed-OTC CCP to increase its margins or default fund could make trading and hedging more expensive and less efficient, to the detriment of systemic stability. EU legislation expressly prohibits competition on margin. The new regulations require greater transparency, which means clearing members and their clients will understand fully their costs of clearing. In Europe, the Futures and Options Association (FOA) has pointed out that a CCP that has an abnormally or excessively large default fund may be in a position to charge lower margin than a competing CCP.

Product Mix and Eligibility. There are many open questions as to permissible product mix or eligibility. What asset classes and instrument types will CCPs of the future clear within the same CCP or subject to the same default fund? Can OTC products be cleared in the same CCP and using the same default fund (and cross netting) as listed exchange products? Taking this one step further (beyond OTC vs listed) to encompass different asset classes as well, Can OTC credit default swaps (CDs) be cleared in the same CCP that handles equity options and energy futures and foreign exchange (FX) forwards? And to what extent will these questions be decided by regulators, or by the CCPs and their members?

Product eligibility must be subject to prudent risk management. The CCP needs to determine which types of trades can be valued, and which are too risky or illiquid to be valued. Even within a category such as CDS, there are enormous differences in liquidity between CDS index and CDS single name swaps, and likewise between one single name and another. It will be easier for the CCP to quantify the risk of those that are more widely traded—both at the time of trade and through the life of the swap. Moreover, unlike many products that have traditionally been CCP-cleared, currently proposed E.U. structure provides that before a new swap product can be traded it must be submitted to the regulatory authority to determine whether it is a product that must be, or does not have to be, cleared through a CCP. A situation could arise where a regulator decrees that in light of the systemic risks posed by the new swap product the swap product must be cleared, but no CCP is willing voluntarily to accept it. (This would presumably be because the CCP does not believe it can adequately calculate or provide against the risks associated with the new product). If the degree of competition among CCPs is greater, then it stands to reason that it is more likely that at least one CCP (or more) will accept the product. It is unclear, but seems unlikely, whether European regulators will have the power to force a CCP to accept a new swap product. If no CCP will accept a swap, then parties to such swaps will have to report them to a “trade repository.”

The CFTC Conflicts Rules proposal addresses product eligibility conflicts of interest concerns through new governance requirements that would ensure that independent directors participate in the risk decisions regarding product eligibility, as well as giving clients of members a voice in the decision. The new proposed ownership rules are also clearly designed to prevent swap dealers or other Enumerated Entities from excluding qualified products from CCPs.

CCP Defaults and Crisis Liquidity. In the U.S., U.K., and Europe, CCPs will have access to central bank funding/liquidity, in the event of defaults that CCPs are not adequately capitalized for. Typically in a CCP there is a default “waterfall” which prescribes the order in which funds are accessed in the event of a default after the defaulting member's margin and other funds are exhausted. There is debate about how much
many of the new products to be CCP-cleared have different liquidity characteristics and a stream of payments over time rather than a single settlement date.

29 There has been strong expressed opposition to competition on this basis, though others contend that this is just one of several lines of defense a CCP has against overall risk. There has certainly been precedent for allowing more risk into the system in other products (i.e., to attract high-frequency trading in equities).

30 For example, a customer executing a trade on Eurex in the Bund, Bohl, or Shatz German Government Bond contracts pays a blended fee that combines both a transaction fee and a clearing fee, without a breakdown of the proportion of each component. Under new regulations that will become transparent.

31 Futures and Options Association, Public Consultation on Derivatives and Market Infrastructures, A Response by the FFA’s European Industry Council (July 2010), at 4.14.


In the U.S., the Dodd-Frank Act authorizes the Federal Reserve to provide broad-based emergency liquidity facilities to non-bank firms such as clearinghouses pursuant to a revised Section 13(3) of the Federal Reserve Act. In Europe, it remains to be seen who will decide whether there is a crisis requiring intervention (and who will drive the terms of the intervention)—the newly proposed European Securities and Markets Authority (ESMA) or the individual national securities and markets authority. It is also unclear how the relevant authority will interact with

the central bank of the relevant nation regarding systemic effects, money supply and other issues. European central bankers have also raised concerns about the implications of CCP access to central bank liquidity for the money supply in the CCP’s home country. European central bankers have called for a high degree of coordination on matters where ESMA exercises its new powers.

Figure 1: The Size of Derivatives Markets: On- and Off-Exchange ($ trn)

Source: Bank for International Settlements, via European Commission 2010

was estimated as $6.15 trillion, while the gross market value was estimated at $21.5 trillion, and gross credit exposure was estimated at $3.6 trillion (see Figure 1). Figure 1 illustrates the notional amount of global OTC derivatives compared to the notional amount of listed global and listed European derivatives. Figure 2 compares the notional amounts and gross market values of the different types of OTC derivatives.
CURRENT OTC DERIVATIVES MARKET AND CLEARING

OTC Derivative Market Volumes. The size of the OTC derivatives market can be measured in terms of either the notional amounts outstanding, or the estimated "gross market value" once hedged and netted positions are taken into account, or the "gross credit exposure." As of December 2009, according to Bank for International Settlements (BIS), the total notional amount outstanding of the OTC derivative market

"Gross market value" is defined by the Bank for International Settlements (BIS) as the sum of the replacement value of all open contracts that are either in a current gain or loss position at current market prices, and is viewed as a measure of market risk. BIS, OTC derivatives market activity in the second half of 2009 (May 2010), at 4, available at http://www.bis.org/publ/othr1005.pdf.

"Gross credit exposure" is defined by BIS as the gross market value after taking into account legally enforceable bilateral netting agreements, but excludes CDS contracts outside the U.S.

CCP OTC Derivatives Clearing Volumes and Institutions. SwapClear is the principal CCP clearing interest rate swaps. At the end of August 2010, the notional amount outstanding on interest rate derivatives cleared through SwapClear was $228.5 trillion. Meanwhile ICE Trust U.S. and ICE CLEAR Europe are collectively the largest clearinghouses of OTC CDS products and as of September 2010 had cleared $12 trillion in gross notional value of CDSs since inception, with aggregate open interest of $1.1 trillion.

Within ICE Clear Europe, this included €3.4 trillion ($4.6 trillion) of gross notional value of CDSs, including €530 billion in single name CDS products, with a

Figures

Figure 2: OTC Derivative Market Segments—$ Trillion (% of total), December 2009

Source: BIS, via European Commission 2010

Figure 3: Existing or Planned OTC Derivatives Clearinghouses, June 2010

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resultant €443 billion ($580 billion) of open interest. In the U.S., ICE Trust has cleared $7.4 trillion of gross notional value, including $455 billion in single name CDS products, resulting in open interest of $494 billion. Meanwhile, CME ClearPort is the largest clearer of OTC energy and commodities contracts, with average daily volume in 2009 of over 583,000 contracts.

While these are the market leaders, there are numerous competitors clearing, or preparing to clear, OTC products. Figure 3 illustrates which institutions had either proposed or were providing clearing services as of June 2010.

CURRENT STATUS OF FINANCIAL REFORM IN U.S., U.K., AND EUROPE

The U.S., U.K., and E.U. all appear well on their way to meeting the G-20 goal for CCP clearing of OTC derivatives, particularly those executed by financial institutions. Autumn 2010 found responses to the global financial crisis continuing to progress in the U.S., U.K., and Europe, characterized by a mix of enacted and proposed legislation and rules, mandates from legislators to regulators to issue new regulations, and “consultations” and roundtables inviting stakeholder comment. In the U.S. and U.K., (as part of their new responsibility for financial systemic stability) central banks will take a primary role in overseeing CCPs in general, and clearing, settlement, and payment entities and activities in particular. In Europe CCPs will be supervised primarily by national securities market regulators rather than national central banks.

The U.S. passed the Dodd-Frank Act in July 2010, and rulemaking under its directives is well underway. Title VII and Title VIII of Dodd-Frank cover regulation of OTC derivatives, market participants, and clearing organizations—primarily by the CFTC and SEC—and extend the authority of the Fed, the CFTC, and SEC to impose additional requirements when clearing of other securities and derivatives is required.

U.S. FINANCIAL REFORM AND CCPS

Dodd Frank Act’s Statutory Structure. The Dodd-Frank Act is divided into 16 “Titles.” Titles VII and VIII are the focus of this section as both address important substantive requirements for clearing organizations. Title VIII extends regulatory authority of the Fed, CFTC, and SEC over clearing, settlement, and payment activities and entities to ensure systemic stability of the financial system. Title VII establishes a regulatory structure for derivatives products and derivatives market participants, under the CFTC and SEC, and generally requires clearing of any new derivative contracts that can be cleared. Title VII also addresses Derivatives Clearing Organizations (DCOs), generally regulated by the CFTC, and clearing agencies, generally regulated by the SEC. “Security-based” swaps are classified as securities, to be regulated by the SEC; virtually all other swaps come under the CFTC. Much of the implementation of Title VII is left to CFTC and SEC rulemaking, which has already commenced with vigor.41

Title VIII—Payment, Clearing, and Settlement. Congress expressly recognizes that systemic stability of the financial system depends upon safe and efficient clearing and settlement to reduce risk for market participants and the overall financial system. However, the entities
and the SEC over CCPs and clearing activities. Rulemaking is generally prescribed to be completed and take effect between 180 and 360 days from enactment of the Act.

In the U.K., the new government presented Parliament with a proposed new approach to financial regulation in July 2010. More detailed proposals and draft legislation are expected by early 2011, with passage of legislation by early 2012. The proposals place the Bank of England atop the financial system with overall responsibility for systemic stability. The Bank would oversee CCPs and U.K. financial regulators.

The E.U. proposed financial reform legislation in September 2010, envisioned as taking effect in 2012. Rulemaking is prescribed for publication by mid-2012. This reform focuses on regulation, clearing, and risk mitigation for OTC derivatives; CCPs; interoperability of CCPs; and trade repositories. Enactment of E.U. legislation is expected in 2010 for a new European Systemic Risk Board and three new European Supervisory Agencies, including the ESMA, which would coordinate with and oversee the national authorities that supervise CCPs in each member country. A proposed revision to the Markets in Financial Instruments Directive (MiFID) is also expected in 2010.

37 Title VII is called the “The Wall Street Transparency and Accountability Act of 2010” and sometimes referred to as the Derivatives Act; Title VIII is entitled “The Payment, Clearing and Settlement Supervision Act of 2010.” Title VII is divided into two subparts, the first (Dodd-Frank Act §§ 711-754) regulating OTC swaps and swaps markets, and the second (Dodd-Frank Act §§ 761-774) regulating security-based swaps markets.

38 This article summarizes Title VIII before Title VII in hopes of greater clarity.

39 Security-based swaps are generally based on a single security or index, or else reference a single issuer or small number of issues in a security-based index.

40 Certain types of swaps are expressly excluded from the Dodd-Frank Act. In addition, foreign exchange swaps and forwards will be considered “swaps” and regulated under the Act unless the U.S. Secretary of the Treasury determines otherwise (Dodd-Frank Act §§ 721, 722). These products have been exempt from regulation since 1974 and performed well without threatening systemic stability during the crisis, so they may well escape regulation under the Act. The Act also provides that swaps may not be regulated as insurance products under state law, per Dodd-Frank Act § 722.

41 On a technical level, the Act provides largely parallel requirements for swaps under the CFTC and security-based swaps under the SEC, but is drafted so that each are dealt with in separate sections of the Act.

42 Dodd-Frank Act § 802 (“Findings and purposes”).

well.43 The Dodd-Frank Act identifies key priorities in regulating and supervising “systemically important” entities and activities in clearing, settlement, and payment:

1. To reduce systemic risk;
2. To support stability of the broader financial system;
3. To promote robust risk management; and
4. To provide consistency.

As a result, the Act gives the Fed Board new authority for supervision of systemically important entities that perform these activities, and also supervision of systemically important activities—even if such activities are performed by entities that are not themselves systemically important. The designation of which entities and activities are (or are likely to be) “systemically important” is to be determined by the Financial Stability Oversight Council (FSOC), subject to specified criteria.44 The Council, a new body created under the Dodd-Frank Act and chaired by the Secretary of the Treasury, consists of 10 voting members (including the Chair of the Fed and the

The CFTC and SEC have been given substantial new responsibilities to regulate and enforce the new laws, and the Fed has been tasked with

but is required to consult with the Council and the CFTC or SEC.45 The Fed is also responsible for reviewing existing or future prudential requirements of the CFTC or SEC to evaluate their adequacy to prevent or mitigate significant liquidity, credit, operational or other risks to financial markets or the financial system. The CFTC and SEC, each may prescribe regulations regarding risk management standards, but only in consultation with the Council and the Fed.

The CFTC and SEC, as applicable, must conduct annual (at minimum) examinations of Designated Financial Market Utilities46 with a focus on:

- Operations and risks;
- Financial and operational risks it poses to financial institutions, critical markets, or the financial system;
- Capability to monitor and control such risks;
- Safety and soundness;
- Compliance with Title VIII and applicable regulations thereunder; and
- Outsourced services.
Enforcement Actions. The CFTC and SEC have been given substantially the same enforcement powers as the FDIC possesses against insured depository institutions. These powers apply both to Utilities and financial institutions engaged in systemically important activities. The CFTC and SEC must confer with the Fed regarding the results of its examination and obtain Fed approval for any proposed enforcement action. The Fed in turn is required to consult with the Council for Financial Oversight.

The Fed also has emergency powers to take enforcement action against Utilities if it believes there is imminent risk of substantial harm, but must obtain majority approval from the Council (and consult with the supervisory agency). The Fed also has emergency powers to perform examinations and take enforcement action against financial institutions engaged in systemically important clearing activities, with additional limitations and again subject to a majority vote of the Council.

Crisis Liquidity from the Fed Window. Designated Financial Market Utilities (DFMUs) are required to maintain liquidity reserves and must report to the Fed on a daily basis. In the event of a systemic shock, the Fed can provide liquidity through the 24-hour window. The Utility cannot draw on Fed liquidity without Board approval. But in that single day a “too big to fail” Utility designated as systemically important could incur enough liabilities to require Fed support.

Title VII—Transparency and Accountability. The Dodd-Frank Act mandates clearing for most swaps by a DCO or a clearing agency registered as such with the CFTC or SEC, as long as (1) a registered DCO or clearing agency accepts the product, and (2) the CFTC or SEC determines that the product must be cleared.

End-User Clearing Exception. Clearing requirements do not apply to a swap if one of the counterparties:

- Is not a financial entity;
- Is using such transactions to hedge or mitigate commercial risk; and
- Notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps.
GFDI: Exemptions from the Fed window. Designated Financial Market Utilities may open an account at a Federal Reserve Bank with features and privileges similar to what a depository institution would have, and may be subject to lighter reserve requirements. More importantly, they will have access to discount and borrowing privileges in exigent circumstances, subject to a vote of the Board and consultation with the Secretary of the Treasury. If such a Utility proposes to make any change that would materially affect its risks, it must provide 60-day notice to its supervisory agency, which must consult with the Fed before responding. This procedure seems clearly designed to protect against a Fed-backstopped Utility taking on new risks that are unexpected or inadequately understood, at the expense of the American taxpayer.

However, there is an emergency exception allowing a Utility to make such a change if it determines that an emergency exists and that immediate implementation is necessary for the Utility to continue to provide its services in a safe, sound manner. The Utility must then notify its regulator within 24 hours explaining the emergency and why the change was needed. The Utility’s regulator must inform and consult the Fed Board, and can then modify or rescind the change. These procedures balance taxpayer expense against a Utility’s need to act swiftly in a crisis, while ensuring adequate supervision and authorization by the Fed and regulators. However, substantial liabilities and risks can be incurred during

End users can elect whether or not to submit such a trade for clearing. In the event that an end-user counterparty does elect to clear the trade, the end user can select the clearing entity (assuming that clearing entity accepts such trades).

There are further definitions and exemptions (and exemptions to the exemptions) not covered here. Some types of financial entities are also exempted: exemption of other small types of financial entities will be determined by their supervising regulators.

**Grandfathering of Older Swaps.** Transactions executed before the Dodd-Frank Act was passed are exempt from clearing requirements, as long as they are reported to a transaction data repository.

**Core Principles of DCOs.** DCOs must register with the CFTC, unless they are already registered with it. A clearing agency registered with the SEC prior to the Dodd-Frank Act that is now required to register as a DCO with the CFTC is deemed registered if it previously cleared swaps or was a multilateral swaps clearing organization.

DCOs are subject to enumerated Core Principles, including:

1. Compliance with Title VII;
2. Adequate financial resources sufficient to cover a year’s operating expenses and to “enable the

organization to meet its financial obligations to members and participants notwithstanding a default by the member or participant creating the largest financial exposure for that organization in extreme but plausible market conditions”;
3. Objective, fair and open participant and product eligibility standards with clear procedures for ongoing verification;
4. Risk management capabilities, including daily measurement of the DCO’s credit exposure to its members and participants, and ongoing monitoring of such exposure throughout the day;
5. Risk management capabilities (including margin requirements) that limit DCO exposure to potential losses and defaults; these margin requirements must be risk-based and regularly updated and modified based on changing market conditions.

**DCO Conflicts of Interest.** Each DCO must have rules to minimize conflicts of interest in the decision-making process of the DCO, and a process for resolving conflicts. The Dodd-Frank Act calls on the CFTC to adopt rules regarding control or voting rights in a DCO by a Bank Holding Company, a nonbank financial company supervised by the Fed or certain other categories of financial institution participating in the swaps market. These rules may include numerical limits. The CFTC must consider improved governance, mitigation of systemic risk, promoting competition, and mitigating conflicts of interest in connection with situations where a swap dealer has a
Regarding governance, under the Proposed CFTC Conflicts Rules CCPs will be required to have independent directors constituting at least 35 percent of their board, with a minimum of two independent directors. CCPs are also required to establish nominating and risk management committees with prescribed independent director participation and leadership. CCPs are further required to allot at least 10 percent of the risk management committee (or subcommittee) to clients of CCP members.

Open Access and Competition. The Dodd-Frank Act addresses Open Access and Antitrust Considerations in several places, but with some substantial apparent loopholes. Any DCO is required to:

1. Protect safety of member and participant funds and rapid access to such funds, with limitations on permitted investments;
2. Clear and public default procedures;
3. Monitor and enforce compliance of both DCO and member compliance with applicable laws, regulations and DCO rules and procedures;
4. Provide safeguards— including disaster recovery, reporting, and recordkeeping;
5. Adequate disclosure to market participants regarding products, fees, margin methodology, financial resources, and daily settlement prices, volumes and open interest;
6. Governance;
7. Conflict of interest minimization and procedures;
8. No unreasonable restraint of trade or material anticompetitive burden.

DCOs must provide sufficient disclosure to confirm compliance. DCOs must designate a chief compliance officer to report to the board, review DCO compliance with Core Principles, review DCO conflict of interest in consultation with the DCO’s board, and prepare and sign an annual report.

material investment in a DCO and conducts business with that DCO.\(^6\)

The Act also calls on the CFTC to adopt rules mitigating conflicts of interest in connection with situations where, rather than a Bank Holding Company or other specified entity, a swap dealer or major swaps market participant has a material investment in a DCO and conducts business with that DCO.

To implement these provisions, the CFTC has issued proposed rules dealing with conflicts of interest for CCPs.\(^6\) The Proposed CFTC Conflicts Rules would apply new ownership and governance requirements to CCPs. Regarding ownership, CCPs would have a choice of two alternatives (or could apply for a waiver):

- **Alternative #1**: No member could own or have voting power controlling more than 20 percent of a CCP. In addition, Enumerated Entities could not collectively own or have voting power controlling more than 40 percent of a CCP (regardless whether they are members).\(^6\)
- **Alternative #2**: No member or Enumerated Entity could own or have voting power controlling more than 5 percent of the CCP.

\(^{6}\) Id. at § 725(3)(p).
\(^{6}\) Id. at § 725.
\(^{6}\) Id. at § 726 (sometimes referred to as Lynch Light). Id. at § 725(d). This rulemaking is intended also to apply in situations where swaps dealers or major participants have comparable investments in boards of trade or swap execution facilities.

See generally Proposed CFTC Conflicts Rules, supra note 12.

\(^{6}\) Id. at § 39.25.
1. prescribe that all swaps . . . submitted to the DCO with the same terms and conditions are economically equivalent within the DCO and may be offset with each other within the DCO; and
2. provide for non-discriminatory clearing of a swap . . . executed bilaterally or through the rules of an unaffiliated designated contract market or swap execution facility.

The language above covers all swaps, but expressly does not require margin offsets or non-discriminatory clearing for contracts of sale of either a commodity for future delivery or options on such contracts. Thus there is no CCP or DCO obligation to provide margin offsets for swaps against futures or options contracts, or to provide non-discriminatory access for clearing swaps as compared to access for clearing the CCP’s existing futures and options contracts.

The Core Principles for DCOs state, under the heading “Antitrust Considerations,” that a DCO shall not (1) adopt any rule or take any action that results in any unreasonable restraint of trade; or (2) impose any material anticompetitive burden. This same clause, however, contains an express exception for conduct “necessary or appropriate to achieve the purposes of this Act”—thus anticompetitive behavior that is “necessary or appropriate” to ensure systemic stability could potentially be permitted.

**CFTC and SEC Rulemaking.** The CFTC has identified 30 areas where rules will be necessary under Dodd-Frank Act Title VII, and has invited public comment via email. Those focused on clearing

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63 Id. at §§ 39.13, 39.25, and 40.9.
64 Dodd-Frank Act § 723(a)(3).
65 Id. at § 725(3)(n).
68 Thus, the comment period was still open while this article was being written, but will have closed by the time this article comes off press.
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