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PAAMCO Perspectives

Are Hedge Fund Managers Prepared for Centralized Clearing?

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Are Hedge Fund Managers prepared for Centralized Clearing?

The 2009 G20 summit called for improvements to the over-the-counter ("OTC") derivatives market, urging 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."[1] The OTC market has long been described as opaque and as contributing to the financial crisis of 2008/2009, and this led to it being a target for reform. An obvious way to regulate this market is to mandate that contracts be cleared by a well-capitalized entity, similar to the way the futures industry is structured. In this way, a central counterparty clearinghouse ("CCP") becomes the counterparty to every trade, thereby mitigating the issues related to counterparty creditworthiness which have undermined market confidence.

Managers have a very short runway in which to prepare for the impact of central clearing. We view this as one of the major operational challenges facing managers in 2012.

Since the G20 summit in 2009, proposals and regulations relating to the trading and mandatory clearing of certain OTC derivative contracts have been drafted by various jurisdictions. These may significantly impact the way hedge fund managers conduct their business, including how they finance their portfolios and manage collateral, which exchanges they will use to trade and which brokers they will use to intermediate the clearing process. Given the approaching end-2012 deadline set by the G20, managers have a very short runway in which to prepare for the impact of central clearing. We view this as one of the major operational challenges facing managers in 2012. Our perception is that some managers are underestimating its impact.

There are a number of key action points for managers to consider:

I. Assess impact on operations

Managers need to assess the impact that central clearing will have on their operations. In the first instance, this means determining which, if any, instruments they trade are eligible for clearing. Secondly, what are the volumes of such eligible instruments traded by the manager?

Operational workflow processes will need to be re-designed in order to accommodate the new requirements. For example, managers may have to establish connectivity to multiple CCPs, trade affirmation platforms, swap execution facilities ("SEFs") and Futures Commission Merchants ("FCMs").[2] Operationally, this puts a premium on having automated data flow in order to facilitate the reconciliation of information moving among all of these interfaces. Furthermore, the frequency of reporting is set to increase. Under proposed CFTC[3] rules, certain swaps will have to be reported in real-time to a swap data repository, increasing the relevance of automated reconciliations. Additionally, increased complexity in managing collateral (discussed below) may challenge managers' current systems and processes in this area.

The above will likely entail investment in additional staff and systems, with the ultimate result of driving costs higher.

CCPs *= Central Counterparty Clearinghouses*

SEFs *= Swap Execution Facilities*

FCMs *= Futures Commission Merchants*

II. Select appropriate clearing brokers/FCMs as intermediaries

The selection of appropriate FCMs is paramount to the manager's preparation for central clearing. In addition to criteria such as credit rating, the FCM should be able to provide robust operational connectivity to CCPs and SEFs. The FCM must also be able to adequately report all trades to the regulator(s) on a timely basis. We recommend that managers utilize at least two clearing brokers in order to mitigate the operational risks associated with counterparty failure.

During the selection process, it is important that the manager performs adequate due diligence to ensure that the FCM is able to cope with the volume and types of instruments traded as well as with the regulatory requirements of various CCPs globally. Once an FCM is selected, an extensive on-boarding process will likely be required to ensure that both parties are ready for live trading.

III. Execute new agreements with counterparties

Managers should assess the operational impact of central clearing on portfolio financing and collateral management (including amounts, eligibility and timing). Generally, the new regulations will increase collateral requirements and likely increase the frequency of margin calls.

Central clearing will require new documentation to be executed. In the U.S., regulators have modeled the framework for cleared derivatives after that of the futures industry and as such, the documentation for cleared OTC derivatives will be similar. Specifically, a Futures Agreement will serve as the contractual relationship between the hedge fund and FCM. An addendum will govern the specific issues relating to cleared OTC derivatives. An Execution Agreement, which allows the manager to trade with an executing broker and then give-up the trade to the clearing broker for clearing, will need to be executed. To complicate matters, Europe is not following an FCM-type model and thus their documentation will be different. The Europeans are working off existing ISDA[4] agreements and supplementing them with clearing-specific documentation. In either case, managers should get the appropriate documents executed well in advance, as the lead times in negotiating such documents will likely increase the closer we get to full implementation of central clearing (because more and more market participants are likely to be scrambling to put them in place).

IV. Assess impact on portfolio financing/collateral management

Managers should assess the operational impact of central clearing on portfolio financing and collateral management (including amounts, eligibility and timing). Generally, the new regulations will increase collateral requirements and likely increase the frequency of margin calls. Margin requirements will vary by CCPs globally, further adding to the complexity.

Managers should negotiate a number of important facilities with their FCMs/custodians to manage this process. For example, the FCM/custodian could provide short-term financing in the event that sufficient eligible collateral is not available or it could lend eligible assets against available ones. Also, they could provide cross-product margining facilities in order to optimize portfolio financing.

The safeguarding of collateral and the related portability of trades, in the event of a clearing broker failure, are key elements to consider, and these will be governed differently depending on the jurisdiction of the CCP used for clearing. For example, the U.S. futures-based model differs from the U.K. model (clearing broker as agent in the U.S. versus principal in the U.K.). This has direct implications for counterparty risk in the event of an FCM failure. Managers trading globally need to consider the various rules before putting their own structural safeguards for collateral in place.

Jurisdictional uncertainty creates complexity and potential for regulatory arbitrage

One thing is certain. Central clearing is here to stay. Once a clearing mandate is issued, managers will likely only have a short amount of time to implement these rules.

Globally, regulators are at different stages of rule-making. In the U.S., the Dodd-Frank rule-writing is arguably the most developed at the moment, with the CFTC indicating that they plan to issue a clearing mandate sometime in the second-quarter of this year.[5] The Europeans, on the other hand, appear to be considerably behind, as they try to coordinate various legislative initiatives (including EMIR[6] and MiFIR[7]) into a coordinated whole.

In Asia, unsurprisingly, the three jurisdictions that appear to be most advanced, albeit at different stages, are Japan, Hong Kong and Singapore. Even though these countries have been studying the proposals coming out of the U.S. and Europe, they have made certain pragmatic choices for their own markets. For example, the Monetary Authority of Singapore ("MAS"), which issued a consultation paper on regulation of OTC derivatives in February, is not currently proposing to mandate the trading of certain OTC derivatives on exchanges or electronic platforms and is not mandating the use of a domestic CCP for clearing.

The MAS's recognition of foreign CCPs is a positive example of cross-border harmonization. If lawmakers do not give due consideration to implementing cross-border solutions then the operational impact of central clearing will be magnified. Possible consequences include contradictory regulation, duplication of margin and reporting requirements and the need for increased compliance resources. Despite harmonization efforts, managers should be prepared for increased costs.

The above raises certain questions. For example, to what extent will regulatory arbitrage opportunities arise? Will a particular swap trade be able to be structured in one jurisdiction to take advantage of perceived favorable margining rules or will it be caught under one or more jurisdictions depending on the domicile of the entities or other factors? The answer to these questions will likely only surface once detailed rules are written and the regulations take effect.

One thing is certain, however. Central clearing is here to stay. Once a clearing mandate is issued, managers will likely only have a short amount of time to implement these rules. Given the complexity described above, it is in their best interest to do their homework in preparation.

At PAAMCO, we have been keenly following the developments in this area and feel that this is an important area for follow-up with managers.

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Notes

1. "Leaders' Statement, The Pittsburgh Summit", September 24-25 2009.
   http://www.g20.org/images/stories/canalfinan/docs/uk/02pittsburgh.pdf

2. In the U.S., FCMs, generally the futures arms of the large broker dealers, will serve as the clearing members for hedge funds.

3. U.S. Commodity Futures Trading Commission

4. International Swaps and Derivatives Association, Inc. ISDA agreements are documents that outline the terms and agreements for OTC derivatives transactions internationally. They are part of a framework of documents, designed to enable OTC derivatives to be documented fully and flexibly, and they set out standard terms that apply to all the transactions entered into between designated parties.

5. The CFTC has indicated that they will issue the first mandatory clearing determination by July 8, 2012, at the latest. See CFTC's "Roadmap to Launch Central Clearing:"
   http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission_020212_1302_0.pdf.

6. EMIR: European Market Infrastructure Regulation. The text of EMIR was agreed by the European Parliament and the Council of the European Union in February 2012. On March 29, 2012 the European Parliament voted to adopt the consolidated version of EMIR. The EU Council of Ministers will now have to approve the text. Concurrently, ESMA (the European Securities and Markets Authority) is tasked with writing detailed standards. EMIR is anticipated to apply from the end of 2012, in line with the G-20 deadline.

7. MiFIR: Proposed Markets in Financial Instruments Regulation, which deals with, among other topics, pre- and post-trade transparency for cleared OTC derivatives.