>> Dodd-Frank's Title VII: Through the Blur, Operational Impacts

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On both sides of the Atlantic, transparency and stability of the financial markets have been the major concern for regulators this year.
The Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) in the US, and the newly created European Securities and Markets Authority in Europe have arrived at similar obligations regarding trading, clearing and reporting requirements.

In the US, the Dodd-Frank law will have a major impact on financial players. However, 6 months after the enactment of the act, it's still a challenge to determine its impact. Considering that many aspects of it are due to take effect in mid-July of this year, where does the law stand?

In this article, we focus on the main points of Title VII and its operational effects.

>> Main requirements in a nutshell

Clearing

Clearing transactions through a clearing house (i.e. Central Counterparty or CCP) becomes mandatory for swaps traded by Swap Dealers and Major Swap Participants. This proposal represents a real transformation of the value chain for over-the-counter derivatives, and all actors in the financial markets are directly impacted.

Execution

Swap transactions that must adhere to the clearing requirements will also be subject to execution requirements, meaning:

- Executed on a board of trade that is designated as a contract market
- Executed on a registered swap execution facility.

Reporting and recordkeeping

Swap dealers and major swap participants will be responsible for making sure that each of their counterparties are authorized to trade swaps, and for providing documentation to the CFTC including all relevant information regarding risks and the characteristics of the swap transaction.

They will also have to maintain daily trading records which will keep track of any related information (including related cash or forward transactions) and recorded communications (including email, instant messages, and recordings of telephone calls) for a period required by the Commission. They will have to provide confirmation, processing, and netting documentation to the CFTC.
The final goal is that market regulators, central banks, prudential supervisors and resolution authorities will have effective and practical access to daily trading data collected by Trade Repositories.

>> Operational Impacts

Memberships and Clearing Houses

Requirement for clearing and execution implies contractual agreements with clearing houses, depositories and boards of trades as well as defining and setting up new processes (i.e. appropriate trading system/information, flow/trade matching/collateral, management/execution).

We can assume that larger entities will be members of a clearing house in order to have the right to trade with any entity.
On the flip side, this means that smaller entities, which will not have access to all trading facilities and clearing houses, will have access to a "reduced" number of participants compared to a complete OTC market.

Most standardized swaps are currently already processed through a clearing house; hence no significant impact is expected in the short term regarding clearing. In fact, big financial entities are already going through clearing houses for standardized swaps, and if they aren't, all trades are subject to call margins and thresholds. However it is likely that the CDS will go through major changes at some point in the future, as the clearing process is still far from being systematic.

It is also probable that various clearing houses will be instituted in the coming year, which will initially create more players, but then dwindle in time.
At first, trading through execution facilities and clearing houses might be slightly reduced due to the adaptation to all the requirements. The liquidity on standardized products will more than likely increase, with participants having access to potentially many more counterparties.

It is also important to note that so far, there is no clearing obligation for non financial entities.

We can assert that most corporate swaps will be cleared by going through clearing agencies, which will therefore render the clearing agencies more competitive with new parties in the landscape, creating a potentially high market development for financial services.

Collateral and Margin Call management

Novation (a substitution of counterparties by a single counterparty for all trades: i.e. the clearing house) will allow a virtual reduction in counterparty risk and therefore systemic risk; it will also allow all parties to drastically reduce their collateral and margin call requirements.

The rating of each entity will be determinant for margin calls and collateral that will be accepted by the counterparty.

In terms of in-house analysis, collateral management will require due diligence on counterparty classifications, in order to check adherence to counterparty requirements.

The list of securities approved as collateral (to be released by the CFTC) will have to be incorporated in the systems for the daily activity.

Also, it is important to note that going through a clearing house minimizes the need for collateral.
However collateral management can be efficient and fully optimized only when the number of clearing houses is reduced (hence decreasing the netted collateral requirement).

Execution

To date, over-the-counter, or « privately negotiated » derivatives have been traded on the telephone and increasingly on electronic markets. There are two sectors on the market: institutional dealer-to-client and inter-dealer. These markets are approximately the same size in terms of trading volumes, but there are many more participants in the client orientated marketplace than inter-dealer.

The direct objective of the Dodd-Frank Act is to stop swap transactions from being privately traded, and to oblige Swap Dealers and Major Swap Participants to negotiate through regulated boards of trade and/or execution facilities.

If traceability will be a major plus for regulators, it will be an equal advantage for financial entities which will see their entire transaction process automated and secured.
Trading platforms will also reduce the number of discrepancies, as all trades will be directly input by the traders into the systems when negotiating, and the chance for mistakes will be greatly minimized.

Repository requirements and Reporting

Swap Dealers and Major Swap Participants are liable for:

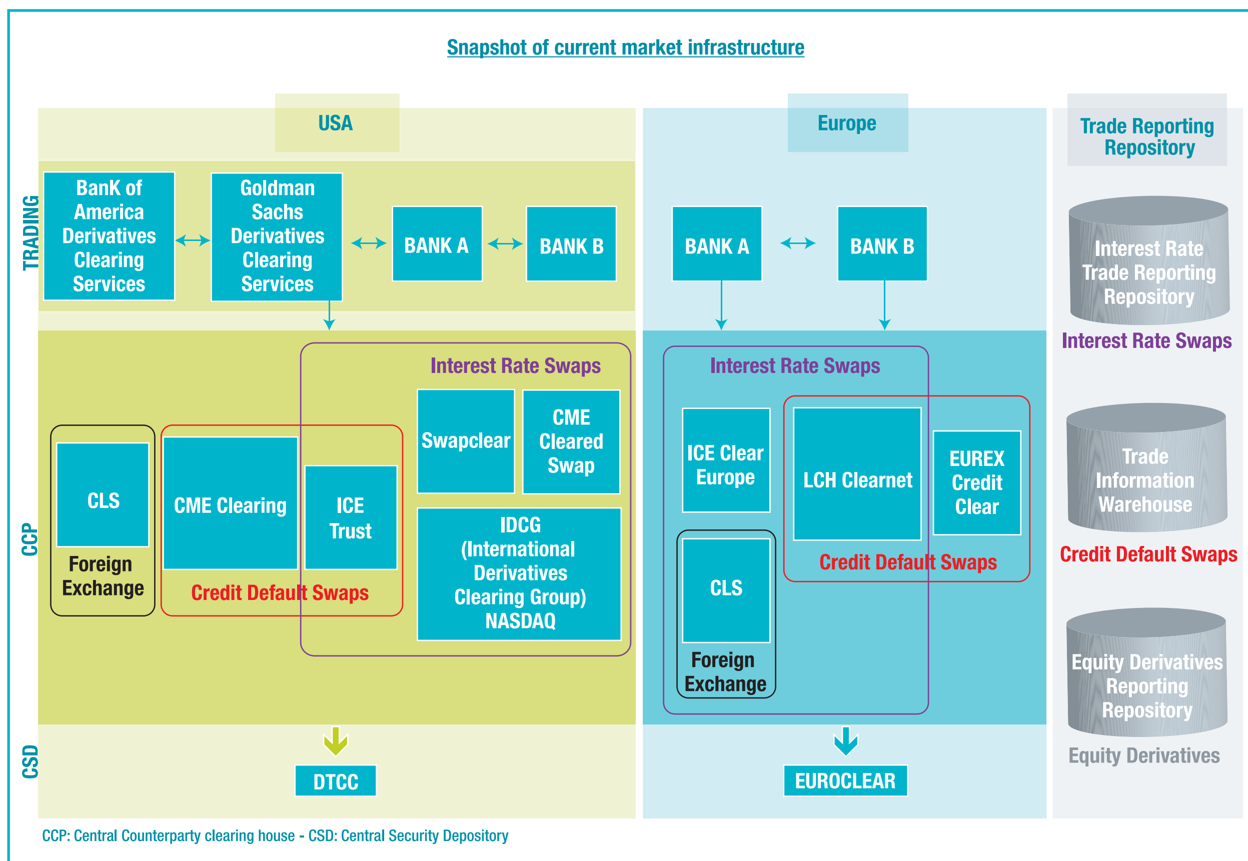
> Mandatory reporting of all trades to a Central Depositary or to the CFTC when no Depository admits the trade

> Requirements for retaining all swap trade information

> Documenting their counterparties eligibility, risks, etc. (for Swap Dealers)

The reporting requirements involved in the act will mainly have an impact on:

> The information retained regarding closed deals (information on non-expired swaps being necessarily already held): impact in terms of information systems and internal data warehousing.



- Additional documentation: further information on swap transactions might be mandated. More than likely the information that will be required is currently included in swap dealers' and major swap participants' systems and will not have a huge impact.
- Documentation on the counterparty's eligibility to trade: this information is also most likely already recorded in the counterparty referential of each swap dealer. However this might require additional information, i.e. systematic information and proofs.

The most immediate effect will be on the reporting requirement, as the effective date of the reporting provisions was the enactment date (July 21st, 2010).

IT alignment

IT will have to be aligned to the newly standardized market infrastructure. Principle changes include the following:

- An upgrade in the identification of derivative trades (i.e. flagged as standardized, cleared, identification of clearing house)
- Reporting: regulatory reporting, real time reporting, data warehousing (which includes new trade and inactive trade information)
- New data links and systems connectivity: market participants will have to align their systems to be connected to new market infrastructures (i.e. trading facilities and contract market, clearing houses, repositories, CFTC), and will need to review their entire IT processes to accommodate these changes.

Risk management

In addition to the evident systemic risk mitigation created by the novation process and its increased transparency in swap markets, this law will also directly impact corporate risk management. The immediate foreseeable outcome will affect both credit and operational risk given the new requirements.

Systematic and Credit Risk

The single counterparty virtually eliminates systemic risk. Counterparty risk will also be eliminated when going through a clearing house or clearing agency.

Operational Risk

The Dodd-Frank Act implies a significant reduction of operational risk, in particular with the implementation of trading facilities, electronic confirmations, and the reduction of backlogs/unmatched trades.
Although the majority of unmatched trades are related to corporate client trades (i.e. those that do not require trade clearing) and not with interbank trades, it is still very likely that they will go through clearing agencies and will therefore also be matched and highly automated.
A major impact will also be the central management of trade lifecycle events, as each event will occur with the clearing house and no longer with multiple counterparties.

Liquidity management

Clearing houses or clearing agencies will be netting collateral and margin calls of all their members, which will therefore allow these members to have lower collateral and cash requirements to margin their overall swap exposure.

>> In Europe

Leaders of the Group of 20 nations want the switch to OTC clearing to be completed by the end of 2012. NYSE Euronext is already working on setting up two new clearing entities in London and Paris for the European securities and derivatives business.
The new clearing houses will become a direct competitor of LCH. Clearnet, and are part of NYSE Euronext's strategic plan to offer clearing services in the UK and in the Eurozone. They will also serve to complement NYSE Euronext's diverse cash and derivatives trading businesses.
London will clear listed interest rate, commodities and FX products, and the new clearing house in Paris will clear equities and equities derivatives products •

SUMMARY

DODD-FRANK TITLE IV: OPERATIONAL IMPACTS ON HEDGE FUND AND PRIVATE FUND ADVISERS

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In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Act. The legislation, effective this July, will have a major influence on market regulations - especially on the asset management industry - by creating new regulators and regulation requirements. Title IV in particular aims to increase the information provided to investors and the quality of reporting to the regulators while mitigating systemic risk. For the first time, Title IV makes registration with the SEC or US states obligatory for most advisers.

Private fund advisers with an AUM over $100 million will need to disclose certain financial, operational and other record-keeping information. As a result, the SEC's power will be enhanced.

While advisers can take it as an opportunity to review and upgrade their current practices, the regulation will nonetheless involve extensive reporting, controls and new processes.

However, by viewing Dodd-Frank as a chance to improve a firm's compliance and control environment over the long-term, the investments in resources and tools for « support » departments can be justified. This may be done by increasing the investment risk governance through risk reviews or creating independent risk manager functions that monitor, analyze and alert top management and/or the SEC.

Dodd-Frank follows a global mandate seeking to augment transparency, reporting and controls while reducing systemic risk, in order to hinder the reoccurrence of a pervasive economic crisis.

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