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Banks/Exchanges: The Futurization of the Cleared Swaps Regime

- Last Friday, Capital Alpha held a conference call with Scott Parsons and Graham Harper of Delta Strategies, a leading policy firm working with industry and regulators on how to implement the new derivatives regime.

- Scott and Graham reviewed nine significant policy decisions that have driven the shift from energy swaps to futures, and they explained how that trend could extend to other asset classes such as interest rate and credit swaps unless some key changes are made to the final swap trading rules.

- All nine policy drivers are discussed in the full note, but the new margin rules, the new swap execution facility (SEF) rules and the vague definition of a swap dealer appear to be the main catalysts of the shift away from cleared swaps to the futures product. To listen to the full replay dial 855-859-2056 using code 570-89113.

<u>Policies Driving the Conversion of Swaps to Futures</u>

Regulatory Uncertainty: The massive new swap regulatory regime has many untested new regulations and some that have yet to be finalized. The sheer uncertainty about who will be considered a swap dealer, how the final SEF rules will be finalized, what will the capital and margin rules be and a host of other important unanswered questions have lead many market participants to prefer the relative certainty of the futures market. Particularly in the energy sector, we have seen a shift because its largely a cleared market already, and the Dodd-Frank Act mandated an end to a number of previously "exempted" markets. How the CFTC finalizes the remaining rules and possibly corrects some of the excesses will go a long way in determining in whether more of the OTC market shifts to futures or embraces the new cleared swap regulatory regime.

Swap Dealer Registration: The CFTC's final definition of a swap dealer is maddeningly vague and will require an almost case-by-case analysis to determine if some larger market participants are actually dealers. As the most complicated and onerous new rules are largely aimed at swap dealers (such as capital, margin, registration and reporting), it is understandable that many buy side and commercial clients would prefer to operate as much as possible solely in the futures market if possible. This was particularly the case in energy swap markets, where many commercial users feared having to register as a swap dealer.

Margin Rules: Probably the biggest single driver is the fact that most swaps will be required to calculate margin using a five-day value-at-risk or VAR methodology (all swaps except for energy, agricultural and metals), whereas most futures are allowed to use a one-day VAR calculation. This means the minimum margin for a futures contract will be significantly less. CFTC commissioners were comfortable

that a future could be liquidated in a day, whereas they were more skeptical of the ability to liquidate a swap. The commissioners felt there was insufficient liquidity, particularly when it comes to financial swaps, to justify a one-day VAR. While this issue could be revisited in the future, unless a new administration comes in, it will be hard to overcome this incentive for regulatory arbitrage as long as it remains.

Eligible Collateral: In futures markets, letters of credit are generally acceptable as a source of collateral, but they will not be allowed in the new cleared swaps regime. This happened because the CFTC staff do not like letters of credit, and they convinced the commissioners to eliminate them for the new swaps regime. However, the same commissioners were reluctant to remove them as a source of collateral in the futures market.

Listing Eligibility and Portfolio Margining: While the new SEF rules have not all been finalized, it is clear that the new SEFs will be limited to carrying listed swap contracts. Regulated futures markets, known as designated contracts markets (DCMs), on the other hand, are allowed to offer both products. As in important incentive, the exchanges are now often offering portfolio margining, which only enhances their product offerings compared to what a SEF could offer.

Tax Treatment: While not all futures benefit from the preferred treatment under IRC section 1256 as 60 percent long-term and 40 percent short-term investments, the Dodd-Frank Act explicitly says that cleared swaps can not benefit from this treatment. This will be an important consideration for certain types of transactions and in those cases there will be a strong customer preference for the futures product.

"Open-Access" or Fungibility: In the futures market exchanges have vertical control, meaning they can chose which trading platforms can integrate with their clearinghouse. However, in the new swaps regime a provision of Dodd-Frank mandates that there be "open-access" to every clearinghouse. That means a swap clearinghouse must allow a swap traded on virtually any platform to be accepted for clearing. This Dodd-Frank mandate gives exchanges a strong incentive to list as many products as possible as a future, where they control the relationship between the trading platform and the clearinghouse.

Some Unfinished Rules

While most of the policy drivers discussed so far provide a clear regulatory incentive in favor of the futures product, there are a few more rules that have not yet been finalized, particularly the trading transparency requirements, that could shift the incentives in either direction.

Trading Transparency: When the rules for SEFS are finalized, it is likely that SEFs may have more flexible execution methodologies, which will be preferable to some customers. Voice brokers will likely be able to continue in the new SEF market and some of the SEF transparency rules may be attractive to customers as well, but there are a number of important changes that need to be made for SEFs to gain market interest. And, at the end of the day, the sheer financial and regulatory cost of trading will likely drive clients to either the futures or the cleared swaps market.

Block Trading: There is no regulatorily imposed minimum size for block trading in the futures market, but the CFTC has proposed a larger minimum for block trading in the cleared swaps market. Those rules are being finalized right now, and

will begin receiving lots of attention in the near future. Some will question why there are such low minimums for block trading in the futures market, particularly in the energy futures that were just developed to bring on board the former OTC swaps business. There will be a discussion of how to create a similar level of regulatory oversight, but for now the advantage will remain with the more flexible futures markets.

Other Unresolved Questions: The trading rules will not be complete before the election, and a change in administration would affect the timing and the content of the final trading rules. A new administration may decide to make changes to either the unfinished regulations regarding SEF and trading rules, or even go back and modify already finalized rules if they seem to be driving business away from this new market.

In a matter of days, the CFTC may finally issue guidance on which contracts must be cleared, on a phased-in basis, starting with interest rate and credit swaps. Once there is a roadmap to clearing, there could be more interest in the type of central trading platform offered by a SEF. It will likely take until the end of 1Q 2013 before you will likely see a new clearing regime in place for interest rate and credit swaps.

Unless the trading rules are changed to address these incentives for regulatory arbitrage, you could very well end up with two markets: one for uncleared swaps and another for cleared futures. It is more likely that a new administration will make the changes needed to provide the flexibility and remove the incentives for regulatory arbitrage that would result in a functioning cleared swaps market. It will likely take a year to know more definitely whether markets will reject or accept the new cleared swap product.

The capital requirements for uncleared and cleared derivatives will also play a role. Uncleared swaps will have a higher capital and margin requirement, but until that is in place the margins will actually be lower than in the new cleared markets. Once the domestic and international harmonization effort is finalized, possibly in the first or second quarter of 2013, it will likely take at least until the second half of 2013 for those rules to be phased-in. This information is needed before the costs and benefits can fully be calculated and that will ultimately determine whether a vibrant cleared swaps market is ever established.

<u>Would Regulators Stop the Shift?</u>

It would be very difficult for the CFTC to prevent the exchanges from offering futures products that have many of the features of a swap. Instead, the CFTC may make changes, particularly if there is a change of administration, that would enhance the attractiveness of the cleared swaps market. If many of the OTC market participants don't like the new, cleared regulatory regime and shift to futures, Chairman Gensler can claim victory in that there is more transparency and anonymous trading in the futures market environment, which Gensler strongly believes are important qualities of a less systemically risky market.

The reaction to futurization of the swaps market so far has been mixed, but those concerned are mostly motivated by a desire to see the new regulatory regime that they spent two years creating work as intended. Outside of that, it's hard to find any fault with the current futures regime wanting to expand its offerings to include products that are the economic equivalent of a swap.

How Are Broker-Dealers Impacted?
The margins for dealers will go down in the SEF or futures regime, though a RFQ function on a SEF would allow for a higher margin. But the block trades in the futures market allow for same features. There is a question of whether volume will increase enough to make up for the lost margin, but it is not clear whether volumes will increase sufficiently. From a company's point of view, much will depend on whether the cost of hedging rises too much under the new regime, in which case the volumes could actually decline. The international negotiations to harmonize the capital and margin requirements of uncleared swaps will delay clarity on this key component of the new incentives, and it may take until the end of 2013 before it's clear how these rates will be harmonized.

How Will MFGlobal and Peregrine Impact the Process?
With respect to ongoing changes regarding collateral protection, there is less incentive for regulatory arbitrage. FCM defaults are usually the result of internal problems, where there really are no protections. However, volumes decreased as a result, and there are some now pushing for tri-party custody accounts, and Delta believes that eventually they will get that. But it will not be cheap and will require bankruptcy law changes. Any insurance regime will not be federally insured, so it would be a smaller program for retail customers. During the reauthorization of the CFTC by Congress in 2013, the issue of enhancing protection of customer accounts will likely be addressed through a combination of measures that will likely include some additional tri-party accounts, some private insurance and other measures like automated electronic reporting of account status.

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