

Gary DeWaal and Associates LLC,  
Gary DeWaal, President

**Exchange or OTC Market: A Legal Perspective**

## The Plan

September 2009 G20 Leaders stated objectives: All standardized OTC contracts should be:

1. By end-2012, traded on an exchange or electronic trading platform;
2. By end-2012, cleared through central counterparties;
3. Reported to traded repositories; and
4. Subject to higher capital requirements if non-centrally cleared.

## Implementation

According to the Financial Stability Board in its 15 April 2013 Fifth Progress Report:

1. The European Union, Japan and the United States (who host the largest OTC derivatives activity) are the most advanced in implementing legislative and regulatory reform. Even so, it is unlikely that the full range of G-20 commitments will be met by end-2013, let alone end-2012.
2. Some jurisdictions expect regulatory measures related to trade reporting to come into effect this year, and some jurisdictions expect clearing requirements to come into effect during 2013 or 2014.
3. Only three jurisdictions have (or expect soon to have) requirements adopted and in force for OTC derivatives to be traded on organized platforms. Some of these requirements pre-date the G20 commitments.

## Implementation

According to the Financial Stability Board there are three principle reasons for the lack of progress instituting the central clearing requirement:

1. Insufficient standardization of OTC derivatives products;
2. No CCP is accessible by market participants located in their jurisdiction that offers clearing for OTC derivatives products most actively traded in their jurisdiction; and
3. There is an expectation that central clearing of standardized OTC derivatives products will occur in their jurisdiction without mandatory obligations because of the various incentives market participants will face, such as Basel III framework for banks and the margining requirements for non-centrally cleared trades.

Also bespoke OTC derivatives are expressly permitted (subject to great capital requirements). End user exception for bona fide hedging also enacted typically.

## Implementation

However for G15 swap dealers:

1. By end-June 2012 over 95% of gross notional amounts of interest rate and credit derivatives asset classes were estimated being reported to trade repositories (little reporting of commodity, equity or FX derivatives).
2. For OTC interest rate derivatives products offered for clearing by a CCP, by end of February 2013, around 50% of their outstanding gross notional amount had been centrally cleared.

## Implementation

### United States

1. Dodd Frank enacted 2010.

2. Per Chairman Gensler on 16 May, 90% of all CFTC required rules now finalized.

- a. Requirements for swap dealers to report to trade repositories implemented by end-2012; all entities and all products by September.
- b. SEF core principles approved May 16; expected to start trading December.
- c. Process for reviewing swaps for mandatory clearing approved. All standardized IRS and credit swaps will be cleared by end of September.
- d. International Guidance needs to be finalized by July 12.

3. SEC, with jurisdiction over securities based and mixed swaps, far behind. Will propose a comprehensive implementation scheduled when completed.

## Implementation

### European Union

1. Legislation (EMIR) adopted by end-2012 mandating reporting of all OTC derivatives to trade repositories. Interest rate and credits swaps required to be reported by July; FX, commodities, and equity swaps by January 2014.
2. Legislation (EMIR) adopted mandating central clearing of all OTC derivatives. Technical rules finalized March 2013. First clearing determination expected by year-end. Clearing obligation begins Summer 2014.
3. Legislation (MIFID II and MIFIR) requiring standardized derivatives to be executed on a regulated venue expected by 2013; implementation during 2014.
4. Trade reporting for IRS and CDS by September; reporting for all other asset classes by January 1, 2014.

## implementation

### Japan

1. Legislation adopted by end-2012 mandating reporting of all OTC derivatives to trade repositories. Reporting required by June.
2. Legislation adopted mandating central clearing of all OTC derivatives. Clearing requirements implemented beginning with certain CDS and IRS products (domestic dealers only).
3. Legislation (Financial Instruments and Exchange Act) passed during September 2012 requiring standardized derivatives to be executed on an exchange or electronic platform; to be phased in up to/over three years.



## Implementation

### China

1. Legislation adopted by end-2012 mandating reporting of all OTC derivatives to trade repositories. No schedule to implement.
  - a. China has financial secrecy and personal privacy laws that can prevent 3d party disclosure of financial information of Chinese counterparties to foreign authorities.
  
2. Legislation proposed to mandate central clearing of OTC derivatives. SHCH approved for clearing RMB FFA in December 2012; not mandated.
  - a. Shanghai Clearing House studying IRS central clearing.
  
3. All standardized IRS and credit derivatives can be traded on the CFETS platform; nothing mandated.

## potential issues implementing the G20 commitments

1. Lack of international coordination (see page 11).
2. Privacy. Privacy laws, blocking statutes, the scope of indemnification requirements and other laws and policies may restrict or limit counterparties from reporting information about a transaction to a foreign trade repository, let alone a domestic one. Moreover the ability to aggregate data across trade repositories is still limited due to differences in reporting requirements from jurisdiction to jurisdiction. Issues regarding uniform product and transaction identifiers must be resolved.
3. Timing. Uneven implementation schedules have unexpected consequences. Mexico is reluctant to impose a mandatory clearing requirement for USD Mexican Peso swaps because such OTC derivatives are not at this time within the US mandatory clearing requirement.

## International coordination

1. Under Dodd Frank, Congress expressed its intent that CFTC and SEC regulations apply to the global swap market where activity has a direct and significant connection with the US
  - a. CFTC has adopted interim rules requiring non-US swap dealers to apply with its transaction level requirements. Entity level requirements are delayed (except for SDR reporting and large trader reporting for swaps with US counterparties).
  - b. SEC has proposed a scheme to defer to local regulations for entity and transaction level requirements where regulatory equivalence,
2. The CFTC will not permit any US person to have its trades cleared through a non-US CCP unless the CCP submits to regulation as a DCO.
3. ESMA is considering not authorizing non-European CCPs that clear swaps. This would subject banks that must comply with Basel III to sustain significant capital issues.

## the benefits

In his opening statement on 16 May, Chairman Gensler of the CFTC decried the unregulated and opaque OTC derivatives that led to the Financial Crisis of 2008. Counterparty credit risk interconnections led to transmitted risk that necessitated government intervention in the United States and the UK especially. Regulators were not aware of the problems until too late.

1. Mandatory clearing and execution will enhance transparency. Market participants will benefit.
2. Disclosure of price and volume information for all OTC derivatives will also help market participants.
3. Enhanced regulatory surveillance. No government bailouts.

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## the concerns

1. **Greatest concern: concentration of risk at clearing houses: Consider 4 CCP failures since 1974:**
  - a. Caisse de Liquidation (1974): Steep rise in sugar prices was not accompanied by margin increases.
  - b. Kuala Lumpur Commodity Clearing House (1983): Crash in palm oil prices led to the default of six clearing members.
  - c. Hong Kong Futures Exchange (1987). Failure to increase margins; no position limits; high concentration of clearing members. Required bank bailout supported by HK government
  - d. BM&F (1999): Sudden Real devaluation caused two small clearing members to default. Central bank intervened.
2. **Protection of customer assets. Legal segregation in some jurisdictions, particularly the US, may not be as beneficial as other protective measures used by counterparties involved in OTC derivatives**
3. **Some end users may not have sufficient collateral – even if end user exceptions to mandatory clearing requirements.**

## futurization

1. The distinction between cleared OTC and traditional futures contracts is becoming increasingly blurred.
  - a. Some exchanges (eg, CME (NYMEX), ICE) already have listed new futures contracts as economically equivalent to existing OTC derivatives contracts.
2. Some laws may favor futures. In the US,
  - a. Cleared swaps margin based on a liquidation horizon of 5 days (except for certain commodity swaps); futures typically based on a liquidation horizon of 1 to 2 days.
  - b. Letters of credit may be posted for futurs margin but not swaps margin.
  - c. Tax treatment may be more favorable to futures than swaps.
3. Comfort with the known (futures vs. swaps clearing).
4. Greater liquidity in futures.
5. International transactions common in futures.

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Thank you.

Questions?

Gary DeWaal and Associates LLC  
1180 Avenue of the Americas, Suite 809  
New York, NY 10036  
(212) 382 4615  
[www.garydewaalandassociates.com](http://www.garydewaalandassociates.com)