NAVIGATING THE COMPLEX WEB OF DERIVATIVE REGULATIONS

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The surge in derivatives regulations is among the most complex challenges facing the financial services industry today. The United States, the European Union, and half a dozen other nations are in various phases of implementing rules that govern the execution, clearing, reporting, and reconciliation of derivative instruments. Regulatory regimes are similar in character but divergent in the particulars, creating a complex web of obligations that have investors, managers, and administrators working to understand their obligations and how to address them.

REGULATIONS ARE COMPLEX, AND VARY BY REGION

Derivatives regulations can be incredibly complex and vary greatly. This complexity is predicated on several factors including fund domicile, products traded, the domicile and regulatory status of the counterparty to a given trade, entity type, trading volume, and other factors.

We can group types of derivative regulations into four broad buckets:

1. A move towards centralized clearing;
2. Electronic execution requirements for trading over-the-counter (OTC) products;
3. Risk mitigation requirements, such as portfolio reconciliation and dispute resolution; and
4. Requirements to report and disclose activity to a trade repository.

One point of note is that the United States and Europe have taken very different approaches in terms of how they are bringing standardization and transparency to the marketplace. The United States focused primarily on centralized clearing and then on implementing risk mitigation and trade reporting processes, whereas Europe's initial focus has been more on the risk mitigation and trade reporting requirements, and currently plans to mandate centralized clearing closer to 2016. This adds to the challenge for managers, particularly those with funds in multiple markets, or whose trading counterparties are subject to additional or differing regulatory obligations.

A second key difference is that the United States' trade reporting requirements center on swap dealers and major swap participants – the large brokers and banks deemed to be systemically important. Where trading with an "end user" – a buy side fund manager, for example – the dealers are responsible for reporting in a one-sided model; their counterparties are not required to report. Conversely, under the European Market Infrastructure Regulation (EMIR) we see a mandate for two-sided reporting where both parties to the trade are required to report to a trade repository regardless of entity type (with certain narrowly defined exceptions).

The third key difference is that most of these regulations focus on OTC derivatives products (swaps and options) across asset classes, with some including foreign exchange. However, EMIR's rules include exchange-traded derivatives such as listed options and listed futures, which makes the European regime more holistic – and more complex.

The end result is that while the types of rules are similar, the implementation of the rules – in terms of timing, format, etc. – is quite diverse. This makes compliance more complicated, and creates a need for managers to have consistent and robust legal and operational support to stay compliant – especially if they are contemplating geographic expansion or investment diversification.

SOME ALIGNMENT IN RULES IS EMERGING

The industry may see a measure of simplification in the future, thanks to efforts to align the different regimes. In particular, the OTC Derivatives Regulators Group (ODRG), which is composed of regulators within the G20, is working toward aligning the differing rules of the members' respective regulatory regimes and areas of oversight. A good example of efforts to create consistency is the standardization of trade identifiers. For the regulations to function effectively, each trade must have a standardized identifier. Right now, each regime has its own conventions – the most popular example is where the CFTC's Dodd-Frank Act mandates the creation of Universal Swap Identifiers (USIs), while EMIR (European Market Infrastructure Regulation) created rules requiring Universal Trade Identifiers (UTIs) for ESMA-member nations. USIs and UTIs differ in format, use, and time of origination, but efforts at reconciliation are underway to bring about a more globally recognized standard, akin to how an ISIN is used for securities, but at the transactional level.

We also are seeing a move toward cross-jurisdictional recognition, and the idea "if you're compliant with derivatives regulation in a country we deem to have appropriate regulatory requirements, we'll consider you compliant here." For example, Europe recently approved equivalency for five Asia-Pacific countries, including Singapore and Hong Kong, effectively stating that if a given entity were compliant with the rules of one of these countries, specific to centralized clearing and/or trade repository reporting, the EMIR-equivalent provisions would be "disapplied."

MEETING THE CHALLENGES IMPOSED BY REGULATION

Compliance with these regulations incurs an operational cost, but in the long view, complexity and preparation are more significant issues than expense. Additionally, the potential fines and sanctions firms could face for non-compliance could be far more expensive than the relatively modest investment in compliance capabilities. Northern Trust and other firms are developing services aimed at providing anticipatory guidance and helping lessen the operational challenges associated with regulatory compliance. That said, the greater challenge is preparing for the future; building solutions to meet the demands of a fund's current situation, while also taking potential future obligations into account as new regulations take effect or as the manager expands into new markets and products.

The other challenge lies in accommodating how regulations affect strategy: hedge funds historically have been known for opportunistic trading – capitalizing on investments quickly in response to market behavior. Some strategies, such as relative value, arbitrage, and special situations, are almost entirely predicated on this concept. In the future, these funds will not only need to obtain the typical sign-offs from their investment and risk committees, but they will also need to address legal and operational requirements related to any country they intend to trade within or counterparty they intend to trade with. The result is that operational and compliance activities, traditionally the reactive purview of the middle- and back-office teams, have a more direct impact on front office decision-making and behavior and are becoming required considerations prior to trade execution.

Within the new regulatory environment, central clearing poses its own challenges. The different clearing houses, privately run and mostly domicile-specific, each offer different products, positional and transactional IDs, middleware support, compression methodologies, opportunities for cross-margining, collateral requirements, etc. This creates a kaleidoscope of divergent operational demands – everything from trade capture to lifecycle event processing to pricing to collateral management – and those functions must be able to adapt to the specifics of each market in which the manager is executing/clearing trades. This complexity is magnified with regulators working to standardize electronic swap execution in parallel, but doing so a little differently in each market and on differing timelines.

PREPARING YOUR FUND TO MEET THESE REGULATIONS

For fund managers who are contemplating how to meet these new requirements, the first step is to engage a good law firm to help determine your obligations, which regimes you fall under, and what entity type(s) your firm manages. Understanding the growth of your corresponding regulatory obligations is the first step toward gauging its impact to your operational model and trading strategy.

Second, you will want to consider how, from an operational standpoint, you will comply with the requirements. Firms that outsource their back and middle office will want to assess the breadth and depth of their providers regulatory compliance capabilities, particularly as it relates to central clearing and connectivity with industry middleware providers, as well as support for trade repositories and other regulator messaging globally. Many firms that manage operations in-house are looking at regulatory change as a catalyst to evaluate outsourcing opportunities more broadly. Choosing the right partner(s) can free you to focus on your core responsibilities for investment strategy and attracting capital while still meeting your regulatory obligations and helping to alleviate your operational burdens.

Lastly, regulatory considerations are not a one-time decision – due diligence, review of requirements and planning for future regulations are ongoing needs. In the new regulatory environment, managers must consider not only the demands of today, but of tomorrow as well – what are the regulatory implications of expanding into new strategies, markets or products? Are my compliance capabilities positioned to handle new requirements as we grow? The result is that, in the same way managers conduct initial and ongoing due diligence on operational service providers, they must now expand that diligence to incorporate a regulatory lens, making sure the compliance programs they have in place can support their needs across markets, regulatory regimes and legal entities.

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