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Derivatives

Don Muller and Joshua Satten of Northern Trust Hedge Fund Services Discuss the Impact of OTC Derivatives Reforms on Hedge Fund Managers

By Jennifer Banzaca

In an attempt to reduce systemic risk from over-the-counter (OTC) derivatives trading, the Dodd-Frank Act fundamentally changed the mechanics of the execution, clearing, settlement and recording of OTC derivatives trades. Among other things, the Dodd-Frank Act mandates central clearing and exchange trading for many OTC derivatives. These reforms will have financial, legal, compliance and operational implications for hedge fund managers. Among other things, hedge fund managers will need to determine whether they wish to adhere to the August 2012 International Swaps and Derivatives Association, Inc. (ISDA) Dodd-Frank Protocol, which is a supplement that will amend their ISDA agreements with swap dealers and major swap participants. See "Katten Partner Raymond Mouhadeb Discusses the Purpose, Applicability and Implications of the August 2012 ISDA Dodd-Frank Protocol for Hedge Fund Managers, Focusing on Whether Hedge Funds Should Adhere to the Protocol" The Hedge Fund Law Report, Vol. 6, No. 4 (Jan. 24, 2013).

To explain some of the impact of these reforms on hedge fund managers, The Hedge Fund Law Report recently interviewed Don Muller, the Global Head of Middle Office Services at Northern Trust Hedge Fund Services, and Joshua Q. Satten, the Global Head of OTC Structured Products at Northern Trust Hedge Fund Services. Specifically, our interview covered topics including: historical OTC derivatives trading practices; the impact of central clearing and exchange trading of OTC derivatives transactions; the Dodd-Frank Act OTC derivatives reporting requirements; posting of margin on OTC derivatives trades; changes in collateral practices for OTC derivatives trades; the financial impact of such reforms on hedge fund managers; solutions available to facilitate OTC derivatives trading post-reforms; and the impact of OTC derivatives reforms on hedge fund service providers.

HFLR: By way of background, can you describe in some detail the process used for executing, clearing and settling OTC derivatives trades prior to the enactment of the Dodd-Frank Act? Among other things, how were such trades confirmed, cleared and recorded?

Satten: Prior to the enactment of the Dodd-Frank Act, and, to a prevailing extent today, OTC transactions across asset classes are done bilaterally. Most trades are confirmed via electronic confirmations. However, depending on the type of trade, the level of complexity (non-standardization) within that trade and the respective operational setup of the counterparties involved in the trade, they could also be confirmed via paper confirmations. Clearing of OTC trades for many years has been isolated to the clearance of vanilla interest-rate swap deals via LCH Clearnet between dealers (currently approximately 60 total members). The industry has experienced multiple evolutions in transaction recording over the years including moving from mostly paper to electronic confirmations; moving from voluntary reporting to mandatory reporting; moving from one-sided reporting to record-matching, etc.

HFLR: How does the requirement for central clearing for most OTC derivatives trades, enacted as part of the Dodd-Frank Act, impact the legal and compliance obligations of a hedge fund manager? For instance, with which parties would hedge fund managers need to execute legal agreements to effect central clearing of their OTC trades? Would hedge fund managers be subject to additional compliance requirements from clearing firms?

Satten: The most immediate way in which hedge fund managers are impacted right now would be the need for them to register for CFTC Interim Compliance Identifiers (CICIs) and Legal Entity Identifiers (LEIs) for all legal trading entities so that they have registered identifiers for their funds. The LEI program is meant to be a single, universal standard identifier for all organizations and firms involved in financial transactions internationally for the purposes of allowing regulators to conduct more accurate financial analyses. The CICI's are a temporary solution to the eventual global implementation of the LEI program.

U.S. swap dealers and major swap participants will also require that their counterparties (including hedge funds) adhere to the Dodd-Frank ISDA Protocol. Beyond this, the legal and compliance obligations are going to be pertinently defined as per (1) your categorization within the CFTC Clearing Phase-In schedule (meaning if you are classified as a swap dealer, a major swap participant, a private fund, etc.) and (2) the domicile of your trading entities taking into account the desired markets for trading and the domicile of their respective trading counterparties. Depending on your categorization, where you are located, what you trade and with whom, your obligations for legal and compliance will differ.

With regard to the execution of legal agreements specific to trading ability, many managers will continue to put ISDA agreements in place with execution counterparties. The base requirement would be to execute FCM (Futures Clearing Merchant) agreements to allow for the clearance of your trades. MiddleWare documentation would also be necessary to setup your operational ability to clear regardless of the FCM used, though this can vary based on execution method. One of the biggest impacts with the advent of OTC clearing is the introduction of anonymity in trade process flow. Central counterparty clearing firms (CCPs) do not know the clients; executing brokers do not know the FCMs and vice versa; and there are no confirmations directly between the broker/FCM or the client/CCP. So the need for Designation Notices, CCP agreements and even ISDA agreements goes away.

We do not expect additional compliance requirements from clearing firms with respect to hedge fund managers outside of any requirements delineated by the CCP's themselves as the clearing firm is acting as a pass-through entity and representative for the client. Accounts must be kept in good standing.

HFLR: How does the central clearing requirement impact the operational steps that a hedge fund manager must take to confirm, clear and settle OTC derivatives trades?

Muller: The central clearing requirements introduce significant change in operational procedure in several different respects. One major change is related to timeliness. In the current OTC world with bilateral trades, you endeavor to confirm your transactions as quickly as possible, but are not given a hard deadline. In the world of cleared OTC transactions, it is expected that deals will be alleged, affirmed and cleared as quickly as possible, but it is required to be completed on the same day as trade execution.

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Satten: The next biggest impact would be the advent of the LSOC (Legally Separate, Operationally Comingled) framework. The intent of LSOC is to protect customer margin on cleared swaps by essentially restricting FCM's from holding customer margin and their proprietary monies or other customers' margin collectively in the same account. This is designed to prevent FCMs from improperly utilizing customer margin to satisfy a deficiency on another customer's account or cover the FCM's own liabilities. Operationally, this means that collateral and trading fees will be settled in one net payment daily rather than [as] today,where there are two segregated settlements daily (one for fees and one for collateral – often managed by separate teams). Stepping back from literal workflow changes, there will be a convergence of operational responsibilities where today we tend to have defined segregated (not necessarily interoperable) groups dedicated to confirmations, trade support, settlements, collateral, reconciliations, valuations, etc. The nature of cleared OTC transactions may require an operational reorganization and retraining to ensure proper, streamlined, time-sensitive coverage. Other impacts would include a change in trading style considering the inapplicability of novations, terminations and amendments for cleared OTC transactions. In its place, new operational activities will need to be supported such as compression (netting of positions with common terms) and portability (moving positions between FCMs or CCPs). Many hedge fund managers will look to their fund administrator to help manage these changes in process.

HFLR: What impact will the exchange-trading requirement for OTC trades have on the operations and the legal and compliance obligations of a hedge fund manager?

Muller: Much of this remains to be seen. LCH Clearnet has recently bought the International Derivatives Clearing Group and their interest rate futures offering. The Intercontinental Exchange has recently announced plans to launch exchange-traded CDS Index futures. The Chicago Mercantile Exchange has been working on their own offerings across asset classes. The vast majority of the impact of the Dodd-Frank Act for market participants is focused on the centrally-cleared trading of OTC transactions via clearinghouses, and much less on the advent of exchange trading. We still really need to see what happens with SEFs (Swap Execution Facilities) and DCMs (Designated Contract Markets).

HFLR: What additional reporting requirements will be imposed on hedge fund managers by the Dodd-Frank Act with respect to OTC derivatives trades?

Satten: This is dependent on your categorization with the CFTC which is predicated on the fund's holdings – OTC asset classes, trading counterparts, notional sizes and trading volumes. SEFs, FCMs, Swap Dealers, CCPs and MiddleWares are all required to report daily on trades as would hedge funds classified as Major Swap Participants.

HFLR: Can you explain how the Dodd-Frank Act requirements will impact the amount and type of margin that hedge fund managers are required to post with respect to cleared and uncleared trades, and with whom such margin must be posted?

Muller: Margin requirements have increased for the most part as CCP's roll out standard collateral regimes in respect to CFTC requirements for ensuring margin posted is sufficient to maintain market stability within certain confidence thresholds. In regards to type of margin required for posting, we can expect an increase in the types of acceptable collateral across currencies and securities allowed for posting towards

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initial margin, but this would differ by clearinghouse. Margin requirements are passed through FCM's to clients via the CCPs daily, and the margin, in turn, is posted to your FCM who posts to the CCP on your behalf.

HFLR: Will the Dodd-Frank Act have an impact on the demand for high-quality liquid collateral? If so, what impact would this have on hedge fund managers?

Muller: Potentially, depending on the hedge fund's respective trading execution strategy, demand could increase. This can introduce complexity to daily collateral and trading management where tracking the equivalent value of whatever types of collateral are posted becomes a standalone process as you may see your posted collateral independently devalued regardless of any change to the value of your trade itself.

HFLR: What other financial impact will these new requirements imposed by the Dodd-Frank Act have on hedge fund managers? For instance, what new costs or expenses will hedge fund managers need to undertake to become compliant?

Satten: This is hard to quantify. There are registration fees, FCM fees and legal fees, to name a few, but also higher collateral requirements.

HFLR: What changes will the central clearing and exchange trading requirements have on the collateral management practices of hedge fund managers?

Muller: The practice of collateral management is going to change a great deal when taking into account the advent of LSOC, the ongoing expansion of acceptable forms of collateral and increased requirements for collateralization.

HFLR: What types of outsourced solutions are available to hedge fund managers to facilitate OTC derivatives execution, clearing and settlement? How are such services charged and what is the range for such costs?

Satten: The costs and services independently vary a great deal. There are platforms for trade execution; there are platforms for trade affirmation; there are reconciliation vendors, valuation vendors, reporting solutions, etc. Ultimately, the vast majority of the process with the exception of execution can be technically outsourced.

HFLR: Will the OTC derivatives reforms mandated by the Dodd-Frank Act impact the other service providers of a hedge fund manager? If so, how will such service providers be impacted?

Muller: As in any market that moves towards central clearing or exchange trading, we might witness both a contraction and expansion of available service providers and what services they are offering. With the standardization of traded contracts, we could see a streamlining of functionalities around more vanilla products that will open opportunity for vendors to provide services normalizing data, collateral calculations, portfolio reconciliation, etc. Conversely, with the advent of exchange trading, you tend to see a vast increase in trade volumes, a corresponding expansion of tradable universes; and an increase in available research-based and brokerage/clearing services. With respect to the centralization of trade execution, we are seeing DCMs and SEFs emerge for the purpose of trade execution. With respect to the need for increased reporting and regulations in general, you can expect an increase in vendors providing reporting solutions that centralize and normalize data to meet these new standards.