SWAPS DEFINITIONS AND CENTRAL CLEARING
HOW DO YOU FUTURE PROOF DODD-FRANK COMPLIANCE?

White Paper
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If you are a senior level operations or IT professional in a bank or other financial institution responsible for choosing and implementing systems in response to Dodd-Frank or EMIR, you will be facing enormous challenges and opportunities in this post financial crisis era.

Do you understand your obligations? How do you decide on systems when some of the regulations’ details have not yet been defined? This paper looks at the recent evolutions of Dodd-Frank around swaps and soon to be defined SEFs. What are the key capabilities required to ensure you are able to comply both now and in the future?

Defining what is a swap

For those that are familiar with the detail of the Dodd-Frank act, you will be aware that defining a ‘swap’ was a key element that was finally announced on 9 July 2012. There are also a further nineteen other rules that must be delivered by the end of 2012. Far from being an end in itself, this keystone has triggered a technology race for businesses to develop and implement compliant systems.

When the US set out to build legislation to formalise over-the-counter (OTC) derivatives trading it focused its rules around swap trades, the most prolific trade types of derivatives contracts. Credit default swaps (CDSs) had been pivotal instruments in the near or actual collapse of major US and European institutions during the financial crisis. Record keeping was poor, the market was unregulated and subject to massive amounts of speculation; naked purchasing of CDSs, when the buyer held no credit that could be defaulted on, was likened to buying fire insurance on someone else’s house.

In September 2009 at its Pittsburgh summit, the Group of 20 (G20) countries agreed that, “All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”

The US authorities put their interpretation of the plans into action via the Dodd-Frank Wall Street Reform and Consumer Protection Act which become law in July 2010 under “Title VII” the Wall Street Transparency and Accountability Act. The detail of how Dodd-Frank affected the markets was left to two market regulators to resolve - the Securities and Exchange Commission (SEC) and the Commodity and Futures Trading Commission (CFTC).

Having established many of the rules since then, the regulators were still lacking one crucial detail; what constituted a swap?

On 9 July 2012 the CFTC designated swaps that will fall under its jurisdiction, including: interest rate and other monetary rate swaps; CDSs based on broad indexes; currency swaps, options and non-deliverable forwards.

But for security based swaps, they would fall under the SEC’s control including: narrow index credit defaults and total return swaps based on single or few securities; debt derivatives called yields and security futures instruments. The announcement of these definitions established the start of the race to comply.

1 See the appendix for the swap definition table
Swap obligations under Dodd-Frank

Firms had already been mulling over the announcement in April that defined who should register as either swap dealer/security-based swap dealer, a major swap participant/major security-based swap participant (MSP) or as an “eligible contract participant” with particular categories based on their level of trading activity. There is still much debate over these definitions with quite a bit of lobbying between various market participants and regulators.

- **Swap dealers** – high volume firms must book themselves in as swap dealer if their total traded value of swaps for the previous 12 months has been over US$8 billion, or US$400 million for security-based swaps other than credit default swaps. This is a significant increase from the original proposed threshold of US$100 million. There is a two-month window for registering once the US$8 billion threshold has been reached. The threshold level is expected to drop to US$3 billion in five years after monitoring by regulators.

- **Major swap participants** – medium activity firms have to register as major swap participants (MSPs); with measures including daily uncollateralized positions of between US$1 billion for rates and US$3 billion for rate swaps, with tests conducted quarterly.

- **Eligible contract participants** – any other firms wishing to engage in the swaps business must register as eligible contract participants.

Each firm’s further obligations such as reporting trades are determined by their category. 60 days after the rules were published in the federal register, swap dealers and MSPs will be subject to swap data reporting and recordkeeping requirements. This means that all communications must include a clear audit trail for swaps and transactions, including all counterparties and clients.

The CFTC has delayed the deadline for compliance with many other requirements until 1 January 2013. Firms will have to conduct themselves in line with new disclosure requirements, telling counterparties about risks and any conflicts of interest. However, for public sector counterparties an independent intermediary is needed to represent them before trading can take place.

The margin requirements will change significantly for products that become centrally cleared. Swap dealers and MSPs will be subject to certain initial and variation margin requirements that will be established once the regulators have completed a period of monitoring the trading activity. If swaps are not cleared, the counterparty can request that a third party custodian is given the initial margin for safe-keeping, to reduce counterparty risk. Capital adequacy restrictions may be also imposed on dealers and MSPs following the period of monitoring, which could extend to eligible contract participants.

Calculating the margin, getting hold of, and then posting the assets required for collateral, will be a new and complex process for some firms.

In the area of margin management there have been two different workflows until now. For exchange-traded derivatives, there is a well-established procedure with the exchange making the margin calls overnight. Due to the long-standing nature of these arrangements, they are processed using relatively old technology in many firms, with a report produced once a day. On the other side, bilateral OTC derivatives trades would have agreements particular to a trade, requiring more up-to-date technology to be used for collateral management and with a function to dispute margin calls where needed.

There is still debate on whether initial margin is required for bilateral deals. On 2 October 2012, ISDA submitted a response to a proposal for margin requirements on non-centrally cleared derivatives. In its view the variation margin in these deals covers the counterparty risk. Imposing initial margin is thought by ISDA to be “unnecessary and inefficient”. Such deals would require all covered entities to create new set ups to meet these requirements (be they in the form of new operational processes, cash and collateral and custodian management needs, new agreements etc.). All of this implies higher costs for derivatives users as they will bear the increased cost of doing business.

To add further weight to this regulation, Basel III has also set out rules making non-cleared trades more expensive than cleared trades, fulfilling part of the G20’s plan internationally. However, despite the definitions now being set, there are still some grey areas of interpretation, such as how to deal with trades that fall under both the SEC and CFTC jurisdictions.
**SEFs – the swap hubs**

The new market structure is already beginning to form. A vast number of businesses are hoping to take advantage of the need to trade swaps electronically by launching swap execution facilities (SEFs), trading venues that will facilitate execution from the start of 2013.

The SEFs are separated into serving either the dealer to client or dealer to dealer, with a few able to offer both.

With over 50 organizations pitching to be a SEF, the market will be competitive but in all likelihood there will be a rapid shakeout. The situation is not dissimilar to that of Europe following the launch of MiFID in 2007, when new multilateral trading facilities were able to compete with incumbent exchanges for a share of equity trading.

Despite the shift of a significant amount of liquidity away from the traditional venues, mainly from Europe’s most liquid market the London Stock Exchange, four years later only one of the twenty plus MTFs that launched have made a profit, Chi-X Europe. It did this after becoming the largest single market in Europe with around 18% monthly market share by volume traded (according to Thomson Reuters).

The OTC market supports a comparison with equities, but it is a far less liquid market. The number of OTC trades done daily is in the tens of thousands. If there are 50 firms looking to set up a SEF it seems unlikely that they can be supported, especially as the collateral requirements for OTC trades will be reasonably heavy, which is more likely to decrease liquidity.

The winners in this contest are likely to be the large firms with a listed derivatives base and clearing houses, which will allow firms to offset margin from both listed and OTC derivatives trades. Both CME and Bloomberg are well tipped for success. The CME seems to be outmanoeuvring other contenders with the planned launch of interest rate contracts in November and has the support of a number of market makers. FXAll, a foreign exchange market, and MarketAxess the bond trading platform both have successful networks for trading cash products that could be extended to the derivatives market.

**The ripple effect – Dodd-Frank overseas**

The announcement of the definition of a swap has triggered a flurry of activity under US regulations but there are still complications in the national rules. Looking outside of the US, the European Securities and Markets Authority (ESMA) has published its technical standards on the regulation of OTC derivatives, central counterparties and trade repositories (EMIR).

Not only is there added complexity due to the different rules, there is also the potential for arbitrage. If regulations are less restrictive in some jurisdictions then there is the possibility that banks will want to do most of their business in that country, or structure trades through a specific market because of less stringent regulations. There may be arbitrage opportunities between different regulations. There is a gridlock of potential competition if rules are not properly standardised across borders.

One of the biggest burdens is posting collateral for trades with central counterparties. The CCP which requires least collateral may well prove to be the most attractive.

As a consequence of the more advanced Dodd-Frank regulation the level of activity is highest in US banks, with European banks showing a great deal of interest dependent upon the scale of their US operations, and Asian banks exhibiting little interest at present. It is notable that in some areas, for example Asia ex-Japan, there is very little movement to introduce regulation. Regulators from Hong Kong, Singapore and Australia have expressed concern to US authorities in a letter about the broad definition of a ‘US person’ in the rules, which includes any firms that have investments in the US market.
Technology challenges in future proofing Dodd-Frank

For trading firms, the clarity offered by the US regulators is in fact a small step in an ongoing endurance race. What is incumbent upon them is the delivery of internal operational changes that will allow them to comply with the rules in the US and Europe, and as they develop, Asia. Firms must be able to support the US framework with systems that can automatically identify the type of trade being conducted, and can then assist the firm in identifying the rule set to comply with.

To achieve this, the new swap definitions must have their characteristics mapped out, into templates so a trade can be assessed automatically and categorized correctly by the system. Once the firm has set up the pre-defined templates in the trading system the workflow should push orders to the correct SEF, send executed trades to the appropriate clearing house and report them to the relevant repository. Any exceptions can be passed to either a manual process with a lawyer to check the trade over or an automated process for exceptions handling.

There are very specific parameters that your chosen system must take into account. Trades must be reported to the regulators by the larger trading firms “as fast as is technologically possible,” though the rules about exact timings are still being discussed. From 2013 the correct legal entity identifier (LEI) must be used, (a system under which every organization has a unique reference number), so that different banks’ positions can be matched more easily, and so that customers can have a standardised reference point. If the firm is a reporting party it may have to generate the unique swap identifiers (USIs). All of the additional data generated by the transactions, i.e. the LEIs, USIs and product codes must be stored within the trading system so that workflow can operate seamlessly.

Trading systems also need to have flexibility to adapt easily to aspects of the regulation that may be coming in the future.

Links will have to be established with the trade repositories, across geographies. The international nature of the derivatives business threatens to make this a significant burden; many Asian countries do not have the regulatory framework in place to offer regional facilities as found in Europe. A lot of connectivity can be supplied via services like MarkitSERV that enables connectivity to multiple OTC clearinghouses (CCPs). The interface to this service can be provided out-of-the box in some of the more advanced trading systems.

In addition to the registration process for swap trading, “Know Your Customer” regulations and reporting must be adhered to, making the new swaps rules an additional part to an increasingly large compliance picture.

Whether or not an organization becomes a clearing member will affect its entire business model and therefore the technology and connectivity model the firm adopts. For clearing houses the choice can affect their future flexibility and their international reach. Ensuring that technology development is considered at the same time as the business reorganization, and not after, will assist in keeping up with the regulations as they change.

Key points to consider:

1. The timeframe for compliance –
   the timeframe for many rules has been relaxed from October 2012 to January 2013, with the exception of reporting and record-keeping requirements. That additional time will assist with the compliance process; however it will still be tight. Upgrading a bank system, taking into account the changes to the technology and the testing, requires up to six months. The regulators’ staggered announcement of finalised rules, also creates a challenge for the development of software. Each system that needs upgrading gets multiplied by each change on the horizon, for example Dodd-Frank reporting is followed later by the imposition of legal entity identifiers, with margin calculations after that.
2. **Tactical solutions** – organizations are being pushed towards the development of a technical solution based around tactical technology upgrades that can be completed within the required timeframes, without any major hit on the core system. To get better permanent solutions in place firms will have to consider the ability of their systems to interface with one another and new systems that will be introduced. At a base level, the data that is stored against trades needs to increase so that critical points of information can be captured: the jurisdiction the trade is done under, the type of trade, the LEI, unique swap ID and the product code.

3. **Extensibility** – firms must plan for inbuilt flexibility in other systems to ensure they have, or can have, all of the relevant data stored. For example, when planning systems, firms need to allow for developments in non-US regulations. If a swap is done under US and European jurisdictions there may be further variations needed.

4. **Frequent upgrades** – will be required to the trading system until all aspects of the regulation are fully finalised. Upgrading constantly is going to be a costly and risky process. One of the biggest challenges many organizations face is that they have a large number of interfaces between fragmented systems. These will have to interconnect with existing and future possible configurations of architecture, taking account of external connectivity requirements, for example with trade repositories.

This creates an interesting situation; for the last five to ten years, banks have tended to consolidate their trading systems, because having multiple interconnected systems is an organizational nightmare, and increases risk and cost over the longer term. Dodd-Frank appears to actively stand in the way of this process, encouraging tactical solutions on such a scale that there is a risk that they will create even greater fragmentation.

### Conclusion

The rules are almost set for the US market; now decisions have to be made by the banks and other market participants. There is every reason to believe that the rule-making process will be a long and winding road, once the full effects and possible unintended consequences of Dodd-Frank are understood.

Each piece of the puzzle has to be slotted into place on time, with an eye on two key issues; compliance in other jurisdictions and a migration to a more manageable IT infrastructure. In the longer term, with so many moving parts, it’s clear that many firms may have to step back and seriously consider a completely new trading architecture that can accommodate these changes both now and in the future, enabling Dodd-Frank compliance to be future-proofed. Implementing such a system now will prevent the need to unwind fragmented technology later.

Such an enormous shift in the way that business is done cannot be anything but disruptive for the firms involved but good management and foresight can offer an opportunity to gain advantage from the new paradigm.
### APPENDIX 1

**Swap Product Definitions – Summary Table**

<table>
<thead>
<tr>
<th>Swap Category</th>
<th>Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not Swaps</td>
<td>Insurance, provided that the beneficiary has an insurable interest, the contract is not traded in a secondary market and the entity providing the contract qualifies as an “insurance company”. Insurance products include the following: surety bonds; fidelity bonds; life insurance; health insurance; long-term care insurance; title insurance; property and casualty insurance; annuities; disability insurance; insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools); and reinsurance (including retrocession) of any of the foregoing, so long as that reinsurance or retrocession is not accomplished by entering into swaps or security-based swaps.</td>
</tr>
<tr>
<td>Consumer Transactions</td>
<td>(for personal, family or household purposes such as real estate transactions, mortgages, and consumer loans)</td>
</tr>
<tr>
<td>Commercial Transactions</td>
<td>(customary business arrangements and commercial transactions such as leases, service contracts, employment agreements, and commercial loans)</td>
</tr>
<tr>
<td>Loan Participations</td>
<td></td>
</tr>
<tr>
<td>Forward Contracts for Non-Financial Commodities,</td>
<td>FX Swaps (except those exempted by Department of Treasury Proposed Determination, April 29, 2011)</td>
</tr>
<tr>
<td>Forward Rate Agreements</td>
<td>not to be confused with “forwards,” which are not considered swaps, as explained above.</td>
</tr>
<tr>
<td>Interest rates and other monetary rates</td>
<td>(including interbank offered rates, money market rates, government target rates, general lending rates, rates from indexes, and other monetary rates).</td>
</tr>
<tr>
<td>Security-based Swaps – SEC Jurisdiction</td>
<td>Yields, where “yield” is a proxy for the price or value of a debt security, loan or narrow-based security index (except in the case of certain government debt obligations).</td>
</tr>
<tr>
<td>Total Return Swaps</td>
<td>on a single security, loan, or narrow-based security index</td>
</tr>
<tr>
<td>Instruments on security futures</td>
<td></td>
</tr>
<tr>
<td>Credit Default Swaps</td>
<td>based on single names, loans and narrow-based security indexes.</td>
</tr>
<tr>
<td>Mixed Swaps</td>
<td>Total Return Swaps that embed interest-rate optionality (e.g., a cap, collar, call, or put) to shift or limit interest rate exposure, or if a TRS also is based on non-security-based components (such as the price of oil, or a currency)</td>
</tr>
<tr>
<td>Participants in a mixed swap transaction must petition the CFTC and SEC, in order to receive a joint order, unless one of the entities involved in the transaction is dually-registered.</td>
<td></td>
</tr>
</tbody>
</table>

The commission also adopted a rule that defines as swaps those transactions that are structured to evade the provisions of Title VII governing the regulation of swaps.

**References**


US Commodities Futures Trading Commission: [www.cftc.gov](http://www.cftc.gov)

The International Derivatives & Swaps Association (ISDA): [www.ISDA.org](http://www.ISDA.org)
About the Authors

Veronique Malbos
Product Manager – Central Clearing & Back Office, Misys

Veronique Malbos is a solution expert within Misys focused on back-office strategy, solutions support and development for central counterparty clearing, collateral management and STP workflow. She has more than 20 years of experience in the financial software industry specializing in the capital markets, including with over 10 years experience with Misys’ flagship OTC derivatives trading solution, Summit FT.

During her time at Misys she has served in a variety of capacities, including project management, pre-sales and product management. Her role has recently been expanded to include responsibility for back-office solution strategy across Misys’ capital markets solution suite. Prior to Misys, Veronique served as a consultant at Simuledge and Quotient, an information technology systems integrator, working in various roles related to client implementations and support, and project management. Veronique has a Masters degree in Corporate Finance and Capital Markets from the Institut d’Etudes politiques in Paris.

David Dixon
Product Manager – Misys Summit FT

David Dixon is a solution expert within Misys with wide knowledge of operational processing within financial organizations. He has more than 30 years of experience developing and supporting banking software, mainly specializing in OTCs, fixed income and back-office processing, including over 15 years with Misys’ flagship OTC derivatives trading solution, Summit FT.

During his time at Misys David has served in a variety of capacities, starting in customer support in London, followed by six years heading a product development team in New York, and then returning to London as a founder of Misys’ Summit UK office where he was responsible for all aspects of customer implementations, upgrades and support. Prior to Misys, David worked his way from programmer to principal system designer in the IT department of a merchant bank developing a banking system from scratch, and then as consultant at various financial software houses. David has an MA in Natural Sciences and post-graduate degree in Computer Science from Cambridge University.
ABOUT MISYS

Misys is at the forefront of the financial software industry, providing the broadest portfolio of banking, treasury, trading and risk solutions available on the market. With 1,800 customers in 120 countries our team of domain experts and partners have an unparalleled ability to address industry requirements at both a global and local level.

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