Derivatives Regulation in the United States

Foreign Exchange Markets and Dodd-Frank Act Transactional Rules

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Dodd-Frank Act signed into law July 21, 2010

- Requires various U.S. regulatory agencies to adopt regulations implementing new standards across a wide range of areas, including derivatives (swaps), systemic risk and banking regulation
- The Commodity Futures Trading Commission (CFTC) is primarily responsible for new regulations governing swaps

The CFTC has adopted many new regulations required by Dodd-Frank, which apply to all foreign exchange (FX) products other than spot, including with respect to:

- “Business conduct” standards governing the relationships between “swap dealers” and their counterparties in swap transactions
- Reporting of transaction information for swaps, both publicly and to “swap data repositories”
- Delivering “mid-market” prices for swaps before entering into the transactions
- Verifying that parties to swaps are “eligible contract participants” with sufficient financial sophistication to bear the risks of these transactions

Market participants have been working to implement the CFTC’s swap regulations, but challenges remain

- Representatives of major financial market participants, including swap dealers, have been meeting with the CFTC periodically to work through implementation questions
The business conduct standards impose a range of relationship- and transaction-based requirements on swap dealers\(^1\)

- **Relationship-based requirements include, among others:**
  - Confirming a counterparty’s status as an eligible contract participant or a “special entity”
  - Conducting due diligence to confirm the true name and owner of the counterparty
  - Confirming how disclosures will be made to the counterparty

- **Transaction-based requirements include, among others:**
  - Disclosing the material risks of the swap, material characteristics of the swap and material incentives and conflicts of interest of the swap dealer before entering into the swap trade
  - Delivering a pre-trade “mid-market” mark for the swap to the counterparty
  - For uncleared swaps, delivering a daily mark for the swap after entering into the trade

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Market participants have questions about how the business conduct standards will apply to prime brokerage transactions

- Prime brokers have ongoing relationships with counterparties, but executing dealers negotiate specific swap transactions with counterparties
- It would be difficult for prime brokers to comply with the transaction-based requirements of the business conduct rule, and for executing dealers to comply with the relationship-based requirements of the business conduct rule

Proposed industry solution

- Prime brokers would be responsible for complying with the relationship-based requirements of the business conduct rule
- Executing dealers would be responsible for complying with the transaction-based requirements of the business conduct rule
- In some cases (e.g., record retention), the business conduct standards would apply to both prime brokers and executing dealers
The CFTC’s reporting rules require swap dealers to report transaction information for swaps, both publicly and to “swap data repositories” (SDRs)\textsuperscript{1}

- “Real-time” public reporting of primary economic terms data
- Confidential reporting to SDRs of complete transaction information, including counterparties’ identities

As with the business conduct standards, market participants have questions about how the reporting rules will apply to prime brokerage transactions

- Executing dealers negotiate swaps with counterparties, but these trades are “given up” to the prime broker
- After the “give up,” the executing dealer faces the prime broker on one trade, and the prime broker faces the counterparty on a second trade with matching terms
- Unclear if both transactions should be reported fully under the reporting rules

Proposed industry solution

- Real-time public reporting
  - The executing dealer should report the primary economic terms, but only for the trade between the executing dealer and the prime broker
  - The terms of the trade between the prime broker and the counterparty should not be reported, since these terms will be identical to the executing dealer-prime broker trade
  - Dual reporting would be duplicative and would distort market volume information

- Confidential SDR reporting
  - The executing dealer should report the transaction information for the executing dealer-prime broker trade
  - In addition, the prime broker should report the transaction information for the prime broker-counterparty trade
  - Since both trades are legally binding agreements, both trades need to be reported to an SDR
  - SDR reporting is not public, so there should be no concern about distorting market volume information
Additional Trade Reporting Issues

- Confirmation Reporting ("Negative Affirmation")
  - Does SWIFT messaging meet CFTC requirements for a "confirmation"?
  - Is the initial report of primary economic terms sufficient for core FX products?

- Additional Price Notation
  - Does this only require separate fees to be reported – or does it also require the reporting of credit spreads?

- Application across borders
  - Who is a "U.S. Person"?
  - Confidentiality challenges

- What steps are necessary to ensure that spot FX is not reported?
  - T+3/T+5 securities settlements are "spot" – but may not be readily identifiable by dealer systems

- Historical Trade Reporting: capacity to upload massive quantities of transactions

- Timing of Trade Reporting: implementation over year-end
The business conduct rule requires swap dealers to deliver the pre-trade “mid-market” mark of the proposed swap\(^1\)

Many foreign exchange (FX) transactions, including FX swaps, forwards and options, are executed in extremely deep and liquid markets for which *de facto* mid-market pricing already exists

- $4.0 trillion of average daily turnover in FX markets
- FX transactions’ daily volume approximately 7.5 times the combined daily volumes of credit, rates, equities and commodities classes
- FX trades commonly executed over electronic trading platforms, which allow for pricing transparency

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Mid-Market Marks

Concerns

- Electronic platforms (both multilateral and bespoke) presently do not include “mid” information
- Voice brokerage also is not equipped with informational tools that would be needed to provide “mid” on a real-time basis prior to execution of a transaction

Proposed industry solutions

- For highly liquid currency pairs (e.g., pairs of CLS-17 currencies), the requirement to provide a pre-trade mid-market mark would be deemed satisfied without any action on the part of the executing dealer
  - Markets for these currencies are liquid and highly competitive
  - Data demonstrates transparent pricing with narrow spreads
- For any other currency pairs, the requirement to provide a pre-trade mid-market mark would be deemed satisfied if the counterparty executes the trade through an electronic trading platform that provides two-sided quotes on a real-time basis
  - “Mid” is available or can be easily derived from public sources
  - “Mid” can be readily discerned by appropriate client classes as the arithmetic mean of bid/offer
Under Dodd-Frank, swap dealers can only enter into swaps with ECPs

- There are approximately 20 categories of ECPs (e.g., financial institutions, corporations with USD 10M of total assets)
- ECP status is a screen to limit swap transactions to sophisticated counterparties
- “Look-through” requirement: In the case of commodity pools, the general rule is that the commodity pool itself \textit{and} all direct investors in the commodity pool must be ECPs

Potential problems with ECP standard for non-U.S. commodity pools managed by non-U.S. managers

- CFTC proposed guidance, not yet finalized, would not apply the “look-through” standard to non-U.S. commodity pools \textbf{if} all investors in the commodity pool are non-U.S. persons
- The CFTC’s proposed definition of “U.S. person” is novel and extremely broad, however, making it difficult to confirm the non-U.S. person status of investors in non-U.S. commodity pools
Proposed industry solution

- The CFTC should adopt a more workable “U.S. person” definition that aligns with existing regulatory categories.
- Dealers should be allowed to rely on either written representations from a commodity pool as to its investors U.S. person status or on the dealer’s own verification of a pool’s non-U.S. status using alternative reasonable means.
- Verifications of U.S. person status should be as of a particular point in time and dealers should be able to rely on those verifications under they become aware that the information is no longer accurate.