infoNet @ FOA

Improved data handling – the key to issues in ETD

Standardising risk management processes

Unintended consequences of regulatory reform

Facing up to the reality of the new regulatory environment

ISSUE 2 | 2013

Welcome to FOA InfoNet

As the details of the swathe of financial market regulations have been released in the past couple of years, a new lexicon has emerged for the many individuals across operations, compliance, technology and business who are struggling to implement those regulations.

Whether it is CFTC's rule 1.73 or ESMA trade reporting requirements under EMIR, the industry has had to work together in almost unprecedented acts of consensus-building to find the most appropriate solutions to meeting the expectations set out by regulators. Along the way, this has led to the introduction of the legal entity identifier (LEI), the concept of the credit hub, discussions around unique product identifiers and ISIN codes and so on. All of this illustrates not only the complexity of the tasks in hand, but also the increasing importance of data, data management, standardisation of processes and transparency.

Of major concern to the market, however, is what will happen to all the new data that will be collected, and is already being collected in many cases. As CFTC officials have made clear, the data that is now being sent to the regulator in respect of reporting swaps transactions is not really fit for purpose. Speaking last month about the swap transaction reporting that began earlier this year, CFTC Commissioner Scott O'Malia said: "Unfortunately, because the Commission's rules did not clearly identify the data fields or the format in which such data has to be reported, the Commission has been struggling with managing and analysing this data. To be clear, inconsistent reporting and variability in the data, as well as technology shortfalls combined with incongruent rules, have made the data presently unusable to the Commission."

This is naturally a concern in Europe, where firms are struggling to get to grips not just with the swaps reporting requirements, but also the ETD trade reporting requirements that form part of EMIR. The FOA is working with member firms to develop an industry approach to the implementation of these reporting requirements, with a specific focus on exchange traded derivatives. Key to this is gaining clarity around the technical standards for implementation in order for firms to adopt an industry standardised approach. A Regulatory Reporting Working Group and sub-groups addressing core issues have been set up to help establish a common reporting approach. Representatives include banks, brokers, CCPs, vendors and trade repositories.

This is a major undertaking and firms will not be filled with confidence while regulators in the US continue to question the benefit of the data they are receiving.

Emma Davey, Director Membership and Member Services
davey@foa.co.uk

Contents

The InfoNet team

Emma Davey
Director, Membership and Member Services, FOA
davey@foa.co.uk
+44 (0)20 7090 1348

Bernadette Connolly
Corporate Events Manager, FOA
connollyb@foa.co.uk
+44 (0)20 7090 1334

David Setters
Contango Markets
david@contango.co.uk
+44 (0)7710 271291

A report on the 14th FOA InfoNet:

Facing up to the reality of the new regulatory environment

From left to right: Sam Tyfield, Paul Willis, Patrick Thornton-Smith, Paul Marks, Robert Walton

Panel session 1:
Improved data handling – the key to long-term and more recent issues in ETD

Moderator **Patrick Thornton-Smith,** Traiana

Panellists **Paul Willis,** ABN AMRO; **Sam Tyfield,** Vedder Price; **Paul Marks,** Citi; **Robert Walton,** FFastFill

Patrick Thornton-Smith Data, the ownership of the results of a transaction or a position, has greater value and significance than it had four or five years ago. Rob, how seriously is the industry taking the whole question of data and data standards across the trade life cycle?

Robert Walton It is unquestionable that the industry has come a long way as regards its management of data in the past 10 or 15 years. With the proliferation of electronic trading and volumes that have increased by an order of magnitude, it is clear that this could not have happened without the industry building systems and data flows that allow it to exchange and manage data.

With the increased focus on risk, more so in the last couple of years, we have seen a further drive for clients to have a very, very good handle of their exposure; for them to pull in data from multiple trading systems, trading different markets, across many different geographical locations and for people to have that real time spanned view across their whole exposure, across all of those different data sources.

Once again this has driven the industry to get better at how it handles data. However, before we all start congratulating each other on a job well done, if you compare us to other industries such as aviation, healthcare and telecommunications, we actually haven't come as far along as they have. We certainly still have a number of issues within the industry that cause a significant amount of cost and overhead on pretty much any project we undertake.

So a prime example of that is how data gets shifted around. The big issue isn't bandwidth any more. The big issue is the proliferation of mapping tables and translation tables that basically plumb our industry together. We've managed to build all of these systems, they're all more or less talking about the same kind of thing, but if we could find a way for them to speak a different language we have done.

We end up having to manage all of these mappings to allow these systems to speak between each other. It's going to be very interesting to see what happens with the onset of the regulatory changes, the onset of this OTC world and ETD world coming together. How are we going to deal with that and create standardisation industry-wide?

If you're on the business side you might not have realised that for many of the projects that you are dealing with, probably 15% to 20% of the work, is spent thinking about things like mappings, data translation and managing that data properly. On top of that, we need to build monitoring, and that all adds to the cost of all of these projects we're doing simply because we've all got the same data, we're just showing it in different ways. We're representing it in different ways.

With the industry facing pressures on profitability in the last couple of years, as a company we have had a greater push from our customers to provide them with efficiencies. How can we adjust our systems to make it easier for clients to do their business, to onboard business, to monitor their business? There are a number of things where, with the changes that have come about from exchanges like the CME, we're having to report more data on execution. We have had to enable more dynamic data-flows that mean that throughout the various stages from user to actually hitting the market, especially in multi-broker networks, we need to be able to configure our systems so that you don't have to configure static every single point along the system unless it is absolutely needed.

Additional pressures will come with the development of SEFs. With portfolio margining, it would make sense for our multi-broker network to be offering on behalf of our clients connectivity to some of the SEFs, so that our clients can execute immediately and quickly into the futures market.

What we found is that a lot of the things that we have done in the ETD space already to manage these data-flows, they actually already lend themselves very well to things that are going to happen from an OTC perspective. I think once again that shows how far we've come because probably six or seven years ago, pretty much everything you did was completely bespoke, you know, we've certainly changed from that perspective.

A few years ago, most of the people that we dealt with were just all about the business, they weren't really that interested in technology. A positive development is that you have people like Paul [Marks] now referring to themselves as technologists, and previously, that wouldn't necessarily have been the case. It's now more and more that we go to see our clients and they understand data, they understand

the importance of what we're trying to do, that we're not just geeks. We're actually trying to build you a framework that's flexible, that allows you to grow into the future, to be able to deal with things in the future that you can't see yet.

PTS Paul Willis, what's your view of the standardisation of data when it comes to complying with global regulations?

PW One of the words that I jotted down while Rob was talking was 'granularity'. When I become involved as compliance officer in the sort of technology projects like transaction reporting, or it may be connecting up a new clearing house, or a new exchange, or whatever, I try and sit there and anticipate what the regulations and what the business model is going to require in 12 or 18 months' time.

Granularity of data is one of the key challenges that I push for because it's a lot easier to design at that stage, no matter how much the tech people or the ops people complain at the start. If you are planning, for example, where initially they were going to collect data, say at the account level, as a compliance officer you may want to build your market abuse monitoring system on top of that. Therefore, you want to see down to trader level of detail rather than a pooled account of several traders.

So I think one of the challenges for compliance officers is to get in to the projects early enough and to understand the implications of what they're going to be handed. Otherwise you may at the end of the project just be handed a black box and you then have to fit regulation around that. So that's clearly one of the challenges.

You talk about regulation coming up. The FOA has set up a working body already looking at EMIR and the implementation impact on that. That's one of my other big concerns as I see in a number of jurisdictions, in a number of asset classes, an unsuitability. This is nothing to do with client categorisation or whether you can sell them derivatives. We had it ten years ago when they were writing MiFID I, that MiFID I is a directive designed for the equity world and we've all had to suffer having to fit it onto a derivatives world.

The risk with MiFID II and EMIR coming together and treating them as a joint piece is that the politicians and regulators are going to try and fit an OTC world onto an ETD world. I refer specifically to the FOA working group on transaction reporting. What they're trying to do is have a dialogue with people like ESMA and explain that the sort of fields that you may expect to see from an OTC trade you should not be demanding from an ETD trade because they're just irrelevant. So it's anticipating what the data needs are going to be and how you're going to provide it.

PTS That's at the one end of the scale. Paul Marks, I'd like your comments because obviously, you're dealing with data capture very much at the front end of the trade cycle, what's your view?

Paul Marks I think one thing to reflect upon is how we got where we are now? Fundamentally the challenges we're now facing are because the market structure is still based on a manual market, the systems and the ways trades are processed are still as if it was a voice trade in a pit.

Historically, organisations have also been managed in terms of front, middle, back office, risk, and as such there's quite a silo-ed approach to the various functions that need to be performed to run your business.

I think what we've seen is a fundamental change in the market structure already in listed derivatives over the last ten years, going from that manual market, to the green screens on Eurex where you had keyboard trading, then synthetic order types, FIX connectivity, multi-broker connectivity, algorithmic trading, sponsored access and so on.

And yet, we're still using the old kind of post-trade systems and trying to bang square pegs into round holes. I've been quite fortunate because I spent 12 years at big FCMs helping to grow the business from its inception into electronic markets, and now am part of a significant investment in people and technology to reinvent electronic execution product at Citi to provide a Tier 1 offering positioned for the future.

As such, one of the first things we did when we arrived was to identify that the way we should work this is back to front, and that really picks up on Paul's last point.

We need to know, where am I going to end up? What do I need to do at the end, and then, make sure that all the data structures and data models are propagated from the front, but then to do that you don't want to be relying on mappings all the way through the systems. You've got to come up with strategic data sources so that you'll only be doing something in one place once, and any other systems that need that data take it from that one place.

When you build these complex data structures and you're trying to do real time surveillance, real time P&L or intraday margin, then, if there's one piece of data in that chain that is wrong or inaccurate the whole thing's meaningless. So data accuracy is absolutely critical. To get data accuracy you have to lock things down hard.

When we developed our new electronic execution platform we started at the back. We understood what we needed. We made sure all that data was in the front end and we fed all the account data, trader data into that from our core system. So when the trade is entered, the data that ends up in the risk, the clearing systems, and the surveillance systems is going to be right, it just can't be wrong.

PTS I agree with you completely, but then, what happens when all of a sudden the regulations change. Isn't it a little bit like trying to build an aeroplane in mid-air, when you're trying to run your business and the regulators say, you've now got to change your structure? Sam, do you think that the industry is working closely enough with regulators through trade associations like FOA to identify these issues?

Sam Tyfield The short answer I think is, yes, I don't know how much harder the industry can work both outwards facing towards the regulators and inwards facing amongst itself. The FOA, the FIA and others are all working really, really hard. I apologise for any regulators here, but I don't think the blame can be placed at the industry's door so much as the regulators' or more likely the politicians' door.

If you wake up in the morning and you read a piece of news that something has gone summarily wrong in the financial services sector and the immediate reaction from the *Metro* or *City AM* is that we must do this and you decide that that is what is going to happen, there's nothing much the industry can do about that.

PTS One of the regulations which is affecting or will affect quite significantly some the process flows is the CFTC rule 1.73, which is involving I think pretty much everybody in the industry at the moment from end user through to FCM. Paul, could you give a brief overview of 1.73, and how that relates to the topic we're discussing in terms of data and the movement of data between various entities?

PM As many of you are aware, 1.73 really is about risk controls and risk management for clearing. Two components of 1.73 were delayed until June 2013 after much concern was raised by the industry. Those two components are to do with unallocated trades at a fund manager level and give-ups. The rule itself is talking about clearing brokers setting risk limits at executing brokers.

The particular challenges with those two components are that you may not necessarily have a legal relationship or a credit relationship with a fund manager. The entity which generally holds the credit relationships and therefore, the risk management is at the underlying fund level. So to try and make an informed risk decision around something you don't measure risk on is very challenging indeed.

In terms of give-ups the concept is the clearer going to an executing broker and asking them to put risk limits on a client, but the executing broker may not know how to translate and apply those limits in their systems. If you magnify that by the whole number of give-ups in the market, which I think the FIA did some analysis on, it was around 60% to 70% in some months, you can see the scale of the challenge here.

Just before Christmas in New York, there was an FIA vendor workshop where vendors were invited in to provide their potential solutions to the 1.73. The vendors pretty much said they don't really have a solution; they can't really think of a truly workable one, so they are just going to focus on full service business. If you're the system to execute and clear you're fine, if you're doing give-ups or taking give-ins they can't really help you.

One of the vendors came up with the concept of a credit hub, following in the footsteps of the OTC market structure, that would effectively require every exchange in the listed derivatives space to ping this credit hub to do a pre-trade credit check before the trade is executed.

One of the challenges with that is you need to know the definition of the legal entity that you're credit checking and we all need to be talking about the same one. So that leads nicely into the challenges of legal entity identifiers (LEIs) for futures, which you'd have to

"To try and make an informed risk decision around something you don't measure risk on is very challenging indeed."
Paul Marks, Citi

have in place across the whole market before you could implement such a solution. That's all well and good, but who will be the registrar of making sure that as an industry we're all talking about the same entity and we haven't got a slightly different name for it?

ST And we're yet to solve for the clearing brokers and executing brokers having very slightly different risk management methodologies as well.

PM Absolutely...

ST So to have the central hub that you have to ping, you're going to have all be working off the same risk management, and that's a back to front example again.

PW This is yet again a requirement that has emerged from an OTC idea. If you're going to do a $500 million swap with a single counterparty you want to check their clearer's going to take it up first, and it's not necessarily that time critical because you've got time to arrange it. Dropping it into an ETD world, frankly what were they thinking of?

And the other thing in terms of unintended consequences is that more and more when I analyse regulation, everything for the last couple of years has been aimed to reduce risk, but ultimately, I think we've reduced risk as much as we can. We're now like a balloon full of water. We're now just pushing risk around the system. The thing that concerns us as a clearer about rule 1.73, leaving aside all the technology and the operation aspects, is what will happen when you DK a trade. Even if you implement your risk limits to check when you take a trade up, what will happen when it triggers a risk limit is that you just say no. Is the client or the executing broker going to wear that risk from the uncleared trade, and I'll be damned if the CFTC can explain it?

PTS So, given all these wide-ranging issues, how do you look at technology holistically across the whole chain?

PM The first thing you need to do is take a step back before you do anything, work back to front, understand where you are trying to get to, and then, at least you can make sure that the people who are working on your front office systems, your risk systems, your clearing systems and your commissioning systems are all heading for the same place. These are big organisations and everyone's still trying to do their own projects, and if everyone's going off at a slightly different tangent in two years' time you're all going to think you've got there and nothing's going to match up.

Once you've defined your data model you need to look at how much it is going to cost to implement, and as you can see, a lot of the problems are not easy to solve. There are many ways to solve them, and so you need to work out what your priorities are – regulation being one of them. Paul mentioned risk is a key concern for any clearer, and so that's naturally an equal top priority. You then need to weigh everything else up against limited resources. Even if you've got a big bucket of investment it's not unlimited and you've still got to try and make some money at the end of the day.

The problem therefore becomes how do you deliver everything you need to in the cheapest possible fashion? There's a couple of ways that you can do that. One way you can do it is you can move all of your internal business onto one platform, and that's something that we've been doing at Citi. Once you've built a future state technology platform it makes sense to move all internal execution desks and all house traders onto that platform. This then helps subsidise the platform for external clients.

The other thing you can do is to look at outsourcing commoditised components. Such as execution gateways and post-trade risk tools. They're fairly proven. They're fairly standardised and so as long as you can put in and pull out the data that you need, the aim is to achieve this in the cheapest possible way. This brings us to outsourcing. Many of you may have seen Deutsche Bank mentioned in the *Financial Times* in October where it was reported that they were encouraging banks to share IT infrastructure and trading platforms. Outsourcing to a third party service provider is another way of doing that, but with clearer segregation.

So that's your systems and your products covered. You then need to look at your technologists that are delivering these products as well. I don't think you can approach trying to bring all of these systems together combining ETD and OTC, and then go and throw the same technology skill sets at it that you used when it was a siloed model. So I think there's a real shift and a real advantage for technologists that do recognise that the future is understanding risk, core services, execution, technology, and a little bit of post trade because they're the skill sets that you want.

This is especially relevant when you're working with outsourcing providers because you need someone that can programme manage, but also do business analysis and get into the detail to make sure your provider is building their component in full compliance of your data model. So you don't actually need lots of hard core technologists.

If you are successful with your approach then you should still have a slice of budget that you've kept aside to differentiate yourselves. Developing new innovative tools that are relevant to today's market, these are the products that you build internally. Citi's Client Money Segregation Transparency Portal is a great example of that. It's not rocket science but it's relevant, and because of the approach we've taken to keep the cost down we can still invest in innovations such as this.

PTS Rob, from a technologist's point of view, where does a firm like FFastFill decide to invest? What sort of risk capital do you think vendors generally are putting out there to try and pre-empt some of the new changes that we're looking at?

RW I think some of the things that people are doing are beyond or outside of the OTC regulatory changes; they are about doing things better. Management information systems, for example, allow us to put an overlaying model that sits above your underlying platforms, whether it be new technology or old technology. The way that they're built these days they're relatively agnostic to how they receive the data and then that allows you to focus on your data, actually get good quality data.

We're having conversations with people now about things like how to collate trade life cycle data with things like invoicing systems so that you can understand how much it costs to deliver this to this customer that allows them to make better business decisions. Good quality data allows you to make good decisions in a good timescale, and I think from our perspective that's certainly where we're looking to invest a lot of our time and effort going forwards.

PTS So, do you think regulations are being implemented correctly?

ST The LEI does have one particular advantage, which is that it can be mooted as an alternative to the dreaded algorithmic registration. Personally, I could see a lot of ways in which the LEI is fallible, because at least on the buy-side every single firm operates in a different way, you know, some buy-side firms have teams which compete for liquidity and for P&L trading the same instruments.

And they might well have the same LEI if that is the data and the structure that is available or mandated, because nobody wants to go very much further than the regulators require because what the regulator is requiring at the moment is cost and time intensive.

So I'm at the moment sitting on the fence in relation to LEIs. The other issue I have, which is tangential to the LEI, is the market abuse regime where you're under obligation to identify market abuse in as near real time as possible. LEIs are a great way of doing that because you can spot trends and individual traders who might be doing something dodgy, but if there is no standardised time clock across the industry it fails.

Well, it stands a significant risk of failure because market abuse at least, particularly in the high frequency space, can happen at such high frequency, in such a short period of time you need to be able to cut out the noise by having the data standardised, including the time stamp. You have to know at what stage in the cycle the order, or the trade, or the fill is stamped, and you have to know that the stamp is the same across whatever markets he's trading off.

RW And in those kinds of timescales it's also where was it stamped, from whose perspective was it stamped?

PW We've got T + 1 automated trade surveillance and we've now got it live across some 25 or 27 markets globally. We're about to enter Phase 2, which is another dare I say, I think 41 markets. Sam and Paul have the advantage of being young and enthusiastic whereas I am, unfortunately, old and cynical. While Sam makes a very good point about regulators looking to LEIs as an alternative to algo registration, this is only to the extent that from the regulators' perspective it will identify the 'who'.

What concerns me about the whole concept of algo registration is that regulators want to know the 'what'. So you may find they still insist on registration of an algo just because they want to have a piece of code whether they can understand it or not. So I like that idea as a pitch to regulators but I don't think they're going to buy it.

The other thing about using the LEI as a proxy for algo registration is, yet again, it comes back to the point I made earlier about granularity – it's still only at the level of legal entity. So if you're doing your market abuse or even your risk management if you're looking at individual desks, or traders, at a desk or trader level the LEI is still not going to give the required level of granularity.

So, although it would be a nice to solve multiple problems with one approach, the LEI project is still just a way of standardising transaction reporting for the purposes of large position, major shareholder disclosure, etc. I still think from the point of view of firms, we have to be prepared to monitor and to be prepared to receive investigations as it were on a much more granular level. The LEI won't absolve us of that.

PM There is already a FIX tag on the CME and ICE for end-user registration. There is also a manual order flag. So for me these are extensible solutions that would be easy for the industry to adopt across other markets because if you can do it on CME and ICE you have the data, so why can't you then roll it out to ten other exchanges? That in combination with the LEI gives you the end-user and beneficiary of the trade.

PW Again, I'm going to be dreadfully cynical because I'm spending about 50% of my life at the moment living this market abuse project and its implementation. One of the reasons we're going to implement 41 new markets for market abuse is we went and looked at them in detail. Pretty much any selection of markets that you think you could deal with together actually turns out to be nothing more than a bit of branding.

So, we're having to implement different data feeds, different parameters, different alerts. Therefore it requires different underlying algos, accessing the data

“Firms… have to be prepared to monitor and receive investigations on a much more granular level. The LEI won’t absolve us of that.”
Paul Willis, ABN AMRO

for different markets, even though it might all be called NASDAQ or BATS or something like that.

I found a new platform earlier this week called BATS Y. I went in and researched it and it said, in summary from the BATS website, “this is the same as our other market but it allows us to offer a different fee structure”. The consequence is that we’ve still got to set up a separate market abuse monitoring system because we can’t combine it with BATS X because it’s a separate data feed. So a lot of this is smoke and mirrors and unfortunately, I think LEI won’t solve a lot of those issues. The exchanges, when they merge, and we’re going to see the next big one with ICE and Euronext, who’s going to bet against in five years’ time all of the markets are still exactly the same trading platforms, exactly the same trading hubs.

How many of those trading platforms are going to merge? How many different trading engines are we running on now, but it’s all going to have one nice big ICE banner on the front of the head office?

PM I do think it’s absolutely critical these days that you have a sort of middleware system that aggregates all your feeds. The market still works on the principle that a trade comes into a ‘pit’ and it doesn’t matter what system it’s come from, who’s done it, was it routed from one user to the other user first. So, you need to have a layer above your surveillance layer where you aggregate all your feeds, you enrich them, you standardise them, and then you pump them downstream. However, you do still have a point because there are still certain feeds that if a client, for example, is doing sponsored access of an exchange you can’t enrich that because you haven’t got the flow on the inbound to get more information on it. Hence you’re wholly reliant on exchanges providing you with full and transparent information, and that’s still an ongoing challenge trying to get real time, fixed drop copies from the exchanges. But there are standards out there, there’s a FIX standard and there are standards in terms of the data required, such as those published in FOA guidance.

RW Even reconciling on the same exchange can be difficult. Say on Liffe, reconciling things like the exchange order ID and the information you’re getting from TRS, if you are not looking in the exact right XML field at the exact right time you can’t correlate the fill you get on the drop copy with the fill you get from the clearing house to manage the two straight off against each other, and that’s the same exchange. You go through the CME and obviously we’ve got completely different symbology from the middle, and then, and trying to work through and resolve issues back, it just slows everything down because we don’t have that standardisation.

PTS Do you think the disparate regulatory environments that we’ve got around the globe, just in the futures arena, are putting the industry at risk by not having a common set of views, be it across different jurisdictions?

ST But there are: I mean the IOSCO, the G20, they all agreed on the aim of what they were all trying to do. So at the very top level there is commonality of intent and approach.

PTS But the practical side…

ST The practical side of it is, you know, all bets are off.

PM This is the single biggest problem because these systems are global. There’s not a system in Europe and a system in the US, and clients in one region can be trading in markets in another. So you have to solve a problem globally. At the moment we’re trying to get our heads around what are we going to do about CFTC 1.73 in the US, and then, we look over to the financial transaction tax in Europe and work out how on earth that’s possibly implementable or calculated and if business can be done in an economically viable way.

You could see people exiting markets because it's just not worth the bother. Part of the problem is that the regulators are trying to move too fast because politicians want to be seen as clamping down. So the normal regulatory process of dialogue and coming up with a solution that's implementable is going out the window and you're seeing stuff come out, and the first you hear of it is when it's law.

RW I was going to say from a vendor perspective it's incredibly difficult because to be honest nobody really engages the vendors as early as they really should. There's just not enough clear guidance from our customers.

PW I would also like to say that, getting on a hobby horse, I think the software industry has some responsibility here as well. Back at the start of last year when we started talking about ESMA guidelines on pre-trade risk management, our market access guys spoke to the dozen or so software companies that provide front-ends to us, and the universal response was, 'what?'. And I put the challenge out to the software industry that if you're going to operate in the regulated space at least pay some attention to what the *Metro*'s saying on the Tube.

PTS Are you suggesting then that the software industry should have some level of regulatory oversight?

PW I'm not actually, although, I have seen that floated in various bits of proposals.

RW We would definitely agree.

PTS But this just adds an extra level of cost onto the business, I mean to have a regulatory structure costs money.

PW Which is why, in principle, I'm against it. However, I think that the software vendors need to help themselves because at the end of the day you are also going to be competitive. So if we go along to a vendor and say 'I'm sorry it's now six months after the ESMA guidelines went in and your system is still not compliant' and they're just saying, 'oh well, we started too late', then that to us as a consumer, as a client, that's not really a reasonable excuse.

Emma Davey We've heard about how important getting the right data is, and the kind of pressures on achieving that and processes of how to get the data out. How confident is the panel that once the regulators get the data, whatever that data is, that they're going to know what to do with it?

PW Oh, ouch, didn't I answer that one earlier about algos? I think I nailed my colours to the mast.

PM They are competent authorities. I'm slightly cynical for a different reason as some regulators are not clear on what they intend to do with the data that they receive. My concern is that they're insisting that the industry collects the data and that the industry has to police itself, however, they are not allowing the industry to approach whatever they are trying to solve for in a meaningful way.

ST But it will be somebody from the industry who sticks his hand up and says 'dear regulator, that chap over there he's done something wrong.'

PTS I'd say that the biggest problem is that a lot of these reporting mechanisms are after the close of play, after the horse has bolted, so to speak.

PM It's also an issue of how many people are reporting the same trade or potentially reporting the same trade on different systems.

PW And it's also simply the sheer amount of time that the regulators take to deal with these things. When was the last time you saw an FSA enforcement case that wasn't something to do with 2009 or 2010 or something like that? So we are indeed collecting all of this data.

We're sending it all to the regulators as required, but then it all goes into a black hole for two or three years, and then they might come back then and say, oh, can you tell me which trader did this. Yes, we can, it will take a week to get the tapes back, and so on. That is not timely, and it is not good regulation .

"I'd say that the biggest problem is that a lot of these reporting mechanisms are after the close of play, after the horse has bolted, so to speak."
Patrick Thornton-Smith, Traiana


From left to right: Nick Solinger, Piers Evans, Paul Marks, Emma Davey, Ted Leveroni, Stephen Taylor

Panel session 2: Standardising risk management processes in OTC and ETD derivatives

Moderator **Emma Davey,** FOA

Panellists **Ted Leveroni,** Omgeo; **Nick Solinger,** Traiana; **Piers Evans,** MarkitServ; **Stephen Taylor,** Independent; **Paul Marks,** Citi

Emma Davey This next panel is looking at standardising risk management processes in the OTC and ETD derivatives area and we have brought together a panel from both sides of the derivatives space.

What are the challenges that come with aiming for standardisation and how do you bring the two sides together, how do you go about finding the standard that will work and will suit everybody and find some kind of common ground? I'd like to start with Paul Marks, in terms of looking at the key issues in standardising risk management processes in derivatives, and particularly, in looking at how we harmonise what we're actually talking about in the first place. Where do you start from?

Paul Marks Firstly, looking at CFTC 1.73, the concept of LEIs that we talked about earlier is a pre-requisite. We all need to be setting risk limits on the same entity if we're sharing them. So let's assume that we've solved that problem and have moved on. Even if we haven't, there's still value in the industry coming together and harmonising how we manage risk on a pre-trade basis.

Harmonisation doesn't necessarily mean we all have to do everything exactly the same way. A good example of that is the market structure that's been devised in the OTC space where there are a handful of standardised models that participants can choose from. It would be advantageous if the vendor community and exchanges talked more about coming up with certain baselines. That's not to say you can't still differentiate yourself by coming up with risk management methodologies over and above the standards, but it really would be an advantage if we were all talking about managing risk in similar fashions.

NS The challenge that people face in the OTC world as OTC products come into the same CCPs as ETD clearing, is that CCPs are accustomed to measuring risk and units of initial margin, and variation margin. The OTC world is not used to trading in those units of risk, though regulations have effectively mandated a set of risk practices that converge on the ETD model.

From the buy-side they're interested in offsets between ETDs and OTC products, but still the entire trading environment is trading in units of DVO1, in the rates market and credit spreads in the CDS market. While there's a drive for harmonisation there's not agreement among the market participants. There's not agreement among clearers on which way to bias the risk management on an intraday basis on how you manage client risk. Is initial margin (IM) just your funding risk, or is IM truly the way you should look at the risk of the client's position on an intraday basis?

The great equaliser will ultimately be how trading platforms embrace risk on platforms. SEFs now don't measure risk in IM because CCPs do. That in the futures world is pretty easy to resolve, but now we have one product traded anywhere, cleared anywhere, and you have liquidity providers who'd like to still make one price in a given product across multiple venues. The force of the regulation says go IM, but the existing market probably has a bias towards standing the way the OTC market used to work.

ED Ted, what processes are we talking about when we talk about standardisation?

Ted Leveroni The information and the models you need for risk have to be standardised and that's been talked a lot about. Some of the areas that historically have been a little bit more mundane and are crying out for standardisation are in the post-trade confirmation and allocation processes. That's because you will need very accurate data to feed the risk calculations.

If you don't get the actual allocation you don't know who the real owner of that trade is and thus at the end of the day the risk calculations will be off and the FCM could have incorrect trades, which result in incorrect risk calculations, which could result in them not taking the trade when they should – and that obviously is a serious problem. Standardisation in the post trade space is very important. While there is automation on the sell-side, the problem is very often on the buy-side where trades are allocated manually.

As a result, until it gets to the sell-side it's essentially useless and it takes time and can be inaccurate or late, and that can impact the risk calculations.

Another area that could be a problem in the future as volumes increase and regulations lead to the futurisation of swaps is how margin calls are actually delivered to the end-user, to the buy-side. Each broker has a different method. If the buy-side isn't processing too many margin calls it's not a big issue.

It can get different statements with different data and they can handle it manually or come up with some sort of spreadsheets and macros to work out how to respond to the margin calls. But as those margin calls increase there needs to be some standardisation on that outbound side otherwise you're going to get late responses to those margin calls.

I know that a group of banks and some buy-side participants have worked together to come up with what they would like to see as a standard. They gave it to ISDA. ISDA has given it to FIA. There's been a consultant engaged to help the brokers to map to it. It might not be now, but at some point it may become more of a priority. Right now brokers are dealing with so much else, but that is something that you're going to hear more and more of as the buy-side has to respond to more and more calls. At the end of the day, margin is managing risk and you don't want to get late responses from those calls and obviously, that's a huge issue. Those are two lesser discussed, but equally important areas that really require standardisation.

Stephen Taylor It's probably worth taking one step back and looking at things in slightly less detail, asking where exactly does standardisation deliver the most benefit to the industry and take a simplistic view on it. We need to look to standardise those processes which are most high impact and, coming from a trading firm, those are the sort of questions and concerns around standardisation of pre-trade controls which we've talked about previously, where things can go wrong and have a massive impact on the marketplace. Then we also need to look at where controls are most complicated. In the panel previously they talked a lot about moving data around, getting data into the right place at the right time, being able to tap that data, and Paul raised the vendor focused comment concerning the creation of a credit hub. These are questions of complexity; they power margin calculations and they power a lot of the post trade processes. There's a high degree of complexity there and standardisation would add a lot.

And then, we need to look at where processes are most highly replicated throughout the industry. Where it doesn't matter what the product is, if you're trading it electronically then you're looking for controls that you understand that are routinely implemented in routinely the same way. We'll talk more later about kill switches, drop copies, messaging protocols and testing. For me it's about linking trade execution and post trade processing, understanding how these fit together and understanding where high impact, high complexity and highly replicable processes themselves can gain most from standardisation.

ED Picking up on your viewpoint, Stephen, that's a very good place to start in terms of looking at what we are trying to achieve. So as opposed to aiming for standardisation for the sake of standardisation, what are the goals? How can you drive for standardisation when you've got different vested interests if you like, and different parties involved? This is a very big question to answer, but who owns these processes, and who should drive the change?

PM Looking at the OTC space I believe the FIA already has been working with FPL, FIX Protocol Limited and I see FIX Protocol as the owner of FIX messaging. So anything that you want to extend on that you really have to get involved with FPL. There are a couple of working groups that are not only looking at OTC, but have taken what has been proposed for OTC and are asking if there is some way it can be extended to listed derivatives, at least for pre-trade fat finger risk controls, because that's highly administrative today. There are many different ways to do pre-trade checks and there's a big need for automating that further. If you can then tie that up with post trade risk systems it gives you a much better way to react to what's going on and change things in real time on a pre-trade basis, and that's not something that's really done widely in the industry today.

The existing protocol as I understand it has three components. The first is where you define entities and their relationships. The second is where you can poll and get back the limits or set limits, and the third one is where you can manage entitlements so that's the concept of kill switches. I also believe that CME has taken a sub-set of that protocol and implemented the third component for their Risk Management Interface. It seems they've taken up the FIX specification for kill switches and implemented that into the marketplace. There's a lot out there, but again, everyone's very busy. It's a case of people having the time to get together to define these standards, to get them signed off by FPL, and then to get them out there and get people writing to them. That's the biggest challenge right now.

ST I couldn't agree more. What's required is a collaborative effort between everyone in this industry. There's a broad spread on this panel, there's an even broader spread in the room today, but everyone needs to be involved because otherwise, if you concentrate the decision making into one group or another group, that group is not necessarily going to understand the interests and the subtleties of every part of the industry.

Take, for example, the ESMA guidelines. That was a regulatory effort; regulators defined ways in which electronic trading systems should be managed and there's guidance, but the regulators didn't talk about implementables. So the FOA and other groups such as FIA EPTA came together to try and work out how we take regulation and turn that into something which means something to people in the firms; the trading shops, FCMs and so on.

These groups came together to set down a number of things that can be done in practice to standardise and improve the management of electronic systems. That's really how all of these efforts need to progress over time. We need to have regulation defining the ballpark, and then, we need to have industry shaping the real implementable solutions. So ownership is shared; and at the same time that's a good thing because it means everyone has an opportunity to add to this process.

ED Piers, you've worked with ISDA and FIA working groups, can you elaborate on that?

Piers Evans Having worked for seven or eight years in the OTC space I think we can see a lot of the standardisation topic in OTC all through that period. People probably remember that around about 2005 the credit derivatives market was in full flight. There were a lot of questions being asked by regulators about who held these trades; had they actually been novated away – and had anybody been informed of that novation or did people still think they were facing a counterparty that had in fact stepped out of the trade long ago; what was going to happen if somebody did encounter what we call a credit event where a company that's the subject of a CDS transaction goes bankrupt, for example, and a payment was due?

That uncertainty about the ability of the industry to cope with a credit event led to a big effort, somewhat driven by a big stick from the regulator, to standardise the confirmation part of that very voice-driven market, which meant that there was standardisation of messaging too because, in order to cope with the increasing volumes, you had to be able to send messages between each other to make sure that everyone was happy that the trade they thought they had traded was in fact the trade that they had traded, and that they knew who the counterparty was and that they had a legal contract in place to govern the trade.

That's something that's been a theme in OTC markets for some time, and now with the Dodd-Frank legislation it's become an even bigger theme. One of the things we've been working on, at my firm, MarkitSERV, is being part of working groups where the discussion about how you can develop and drive those standards is taking place; this is so that we will be able to respond to this great wave of legislation that is washing over us.

To some extent that means interpreting the kind of regulatory solutions we think need to be implemented in response to legislation that is not yet clear, but also coming up with a sensible solution for that implementation so that it is easy to integrate to. And an implementation that everyone agrees on is one that should be cheaper to deliver and to integrate to.

Where protocols are agreed, you can be confident that (back to the LEI point) you are all talking about the same counterparty in the same way; you're not using some internal system mnemonic and you can talk to the outside world in a way that your counterparties will understand. That effort has to be pursued and it's something that we found in the OTC market over the last ten years has been extremely useful in terms of trying to sort out those confirmation issues I was talking about with CDS. As that voice-driven OTC market is now going electronic, it's a very hot topic for us, but it seems that it takes a certain desire on behalf of the industry to want to arrive at that point. If you could standardise things sufficiently there seems to be no reason why you couldn't have a protocol that would allow for, for example, pre-trade credit checking in real time to be provided, which is also a very hot topic with the impending need to implement CFTC 1.73.

Nick Solinger The regulations are clear, the business model is clear. If you're a clearing member you have an obligation – so you own it and you share the responsibility to protect your client's money with those risk controls. So many of the standards are owned by the FCM, but there are other players who want to own the standardisation, and they want to own it for a variety of reasons. The regulations have tossed the market structure up in the air. CCPs think that they can enforce client limits pretty effectively too. So you saw very early moves by CCPs to enforce client limits and to create a scheme for doing that. SEFs have come out and said, 'we don't want dependency on outside sources for limits. We want to own it and keep limits within our framework because then clients will more likely trade on one SEF vs. another.'

It really is interesting to see it's not settled yet, the standards bodies have had to cater to this diversity of opinion. So while the standards are going to make it much easier, lower cost for everyone they actually don't settle the point of who owns it, except that the liability is on the FCM to post margin on behalf of the client. So the buck stops at the desk of the head of the FCM, but it's not clear what environment the FCM will have to contend with yet in order to enforce their limit. Unfortunately the regulations are very clear on the sanctions against FCMs for not doing a good job of enforcing it, but they're actually pretty squishy about what happens if an SEF screws up in their calculation and approves orders that go through or vendors or anyone like that.

It's a nerve-racking world to be in if you're extending credit because the environment in the ETD space was actually pretty well tested. You were pretty certain you knew who had the risk and who had liability when things went wrong, and that will get sorted in the next year, but it's not sorted yet. You also have buy-side firms who have a view of how to take a position on the way risk gets managed. You have people who want to accelerate the growth of electronic trading of OTC products who want to see them traded as futures, who want to see things preserved in a block trading market to kind of keep things as they were.

ED So from what you're saying then it's not so much who owns it, it's who's got the most to lose if it goes wrong.

NS That's part of it. Also how you gauge the different influences, participate in the market effectively to ensure that the right outcome happens from your perspective. Not everyone agrees on what the right outcome is.

ED You talked about the buy-side, Nick. Looking at establishing the best practices for end-users from a risk management point of view, how important is that, and again, how do you go about achieving it?

NS It's exceptionally important for buy-side folks who are not used to trading on credit explicitly, who are not used to posting collateral to back up their trades. So a big change for the market that's coming in is a market that was traded bilaterally up until now, that was traded

"Where protocols are agreed, you can be confident that you are all talking about the same counterparty in the same way."
Piers Evans, MarkitServ

based on the risk profile of the client as opposed to posting collateral using standard margin requirements. When we talk about risk and standardisation of risk you now have asset managers who are going to use multiple clearers who are already wrestling with how to post collateral and now they'll have to have funds that are custodied and cleared in different places. They'll need to sort out how they manage that. If there's not standardisation of risk practices and how much collateral they need to pose to back up a given position it's going to be very hard for them to manage their business – allocation processes and all of those things – and be fair in how they allocate trades even when they're allocating across funds that are custodied at different shops. It's essential to the buy-side community to get some consistency.

TL We have those clients that are used to handling margin but there are others that have come from the OTC side that are used to managing their collateral daily and, also, disputing collateral when they disagree with their counterparty. However, they can't do that in the cleared world, and I wouldn't suggest they should because it just doesn't work in a clearing environment when the FCM has to send out the margin to the CCP, but in managing the whole collateral process the buy-side has also consolidated their OTC and their ETD operations.

So you do need standardisation in processes, not only in systems. As you start getting OTC operations personnel now managing the margin process for the ETDs they start wondering, well, I can't dispute this call, but I would like to validate it and that's not something that you traditionally have seen, except for some of the larger clients in the ETD space. But you're going to start seeing the end-users, the buy-side, saying I'm going to start validating this and then I'm going to have very difficult conversations with my FCM next week or next month because they've been overcharging me or I disagree with some of these margin calls.

And so the only way to do that is either to calculate the calls themselves and that can be expensive, or have links to the CCPs and get what the CCP thinks the call should be just to make sure that if the FCM is putting a margin on top of that, that it's appropriate. That's something I've seen the buy-side start talking more and more about. I believe it comes from the fact that you now have OTC operations people starting to consolidate with the ETD side and saying, well, this doesn't make sense, I'd like to check what my bank says.

PM The number one thing the buy-side wants, except for that certainty of clearing, is transparency. It's all about transparency, and that ties into both the points you are making, Ted. They want futures clearing and OTC clearing from one provider and they want transparency on that complete picture... and they want real time margin on all of that. So you have to build the ability to replicate the CCP margin methodologies across both listed and OTC venues to be able to calculate that real-time portfolio margin value, and then, take that data back into your risk systems. Then you want to be able to loop back and update your pre-trade limits off the back of that revised portfolio view.

Without that standardisation, without openness in all the various electronic execution systems across listed and OTC, you can't close that loop. We just can't deliver what our clients want around pre-trade risk checks/certainty of clearing without that piece of the puzzle. Of course we'll build what we need to build and we're sure we'll ultimately get to the point where there is a standard – and we'll drive it ourselves as best as we can – to ensure that there is a solution out there that is easy to integrate to. Obviously, there are a lot of people that are working collaboratively across OTC and listed to get to that point, such as in the FIA/ISDA working group structure, but that's really what the client wants: it's transparency about where their money is: where is my client money held, what's my P&L in real time and therefore what line is available to me to trade right now?

ST I'd like to pick up on that point. From a trading firm's perspective, they really want to be able to go that one step further. Piers alluded to the cost of not standardising processes. Well, clearly a trading company would like to be able to anticipate what its margin is going to be, pre-empting capital constraints before they arise. What collateral it will require. What capital it needs to put where. If it's expensive for an FCM to be able to emulate all of these clearing methodologies and aggregate the data that feeds into them, well, it's certainly expensive for the trading firms.

So standardisation is critical. Coming back to Piers' point, standard approaches towards margining, standard approaches towards messaging drive down the cost of being able to aggregate the data, build the calculations in a standard, safe, one-solution-fits-each-problem approach within the firms. This enables each firm to be proactive about how they spend their capital. It means they can make trading decisions in an informed way, and at the end of the day (and increasingly, in real time). There are no surprises when the FCM looks at a firm's margin utilisation.

And clearers can then know darn well that the trading firms are behaving responsibly. So it is super important that standardisation occurs to drive down the cost of trading. Without it firms are going to cease being able to act in the appropriate, responsible way which we all desire of them. The costs will be prohibitive.

TL A point not often discussed is that there's this waterfall in the CFTC rules on risk management that stops at the buy-side. As a buy-side firm you're obligated to enforce the clearing broker defined limit on yourself before you trade, and that obligation is really challenging if you have multiple clearers using different models of enforcing limits on you.

The obligation is one that a hedge fund might be able to delegate out to the SEF because the SEF can do a check, but at the moment you're an allocating firm, which a lot of the firms that we're talking about are, they're trading in a block, the SEF has no idea how the trade's going to be allocated. There's this additional layer of risk management that the buy-side if they manage their part of the money has to manage. I've found in talking to firms maybe one out of ten is aware at this point of their obligation under the new rules. It's a big change.

ST It's important to make a distinction from a trading firm's perspective between taking feeds of this information from their partners and service providers and being able to recreate these risk and margin calculations themselves. You'll find, that at any given moment, we'll all have a different opinion of exactly where the future is trading. Moreover, perhaps a firm is anticipating where a future might trade at some point in the near future. Perhaps that is the 'drive price' the firm wishes to push through into their risk and pricing models. We'll definitely all have a different view on where the volatility curves are set for options, there's no doubt about that.

Many exchanges are quite active in the way they manage volatility curves, but they will not have the same models, and they will not be doing it in the same way, as the trading firms which are perhaps market-making or prop trading these contracts. You want, from a firm's perspective, to be able to do that off your own drive prices and your own information. You want to be able to do it cheaply. Again, that demands standardised approaches towards solving this particularly complicated problem.

PM The next question that the client asks is, 'What if?' What if I want to do this trade, what does it mean to my margin calculation? So not only have you got to have the engines calculating exactly where they are in real time, you have to be able to take what they want to do, crunch a number, give it back to them because if we are looking at the OTC component, depending on the FCMs position at the various CCPs the cost of one FCM doing that trade for that client could be totally different to the cost of another FCM who has an opposite position at the clearing house.

PE Another thing that we're hearing in conversations with buy-side customers is you used to talk about smart order routing, best execution, now you're talking about the collateral optimisation and where should I put this trade, which FCM should I put it with, what CCP should I put it on in order to get the best utilisation of the, frankly, not very many liquid assets that I've got that I've had to post in this collateral. So I absolutely agree with that.

PM We've already cleared a huge amount of notional on OTC and we've seen real life cases where one CCP, because of its margin calculation at a particular point on the curve, comes up with a hugely different margin call number versus another CCP, and that's massively important to the client in terms of capital utilisation.

TL It's interesting that the clients are calling you. To me that screams out that there should be something out there because you might not be the only FCM where they're executing. So they have to call each one of them and come up with each of the variations of which way this trade can go, who it executes with, who it clears with, what CCP it goes to, taking into account margin, fees, execution etc. You mentioned that this is a place for standardisation to help, to me it's a problem screaming for an answer and I don't know what the answer is because the answer probably isn't calling each of your brokers and working it out. That doesn't sound efficient to me. The answer is finding a pre-trade analytics solution that takes into account all of these things.

PM I've been talking to some vendors in the ETD space about the concept of smart order clearing. So basically if you've got a multi-broker network and you've got access to several brokers' 'What if' calculators you could have a concept where a client can ask to do a trade and if he can do it within these parameters, on these venues, via these CCPs and clear through these FCMs

"It's a problem screaming for an answer. I don't know what the answer is because it probably isn't calling each of your brokers and working it out."
Ted Leveroni, Omgeo

then get it done. This is looking forward a few more years, but there is potential if you can get those extra calculations bolted into a pre-trade model.

ED Where do SEFs fit in the newly standardised world?

PE One thing we're seeing now is uncertainty as to what a SEF really is. The CFTC has mapped out some broad statements, the SEC has said less, but we haven't had the final SEF rules and there are many people who've been waiting for two years to become a SEF and, much as they want to be one, they're just not sure quite what it is yet. That means there are a lot of new entrants, potentially, into that space who are not the traditional inter-dealer brokers that we know from the OTC market, and they're not the current RFQ liquidity providers.

They're new guys who've potentially never done a trade before and, back to the question of standardisation and risk measures, this is really key here because if you say 'Yes, that guy can be a SEF, turn them on to start trading now', you have to be fairly happy that the risk checks they're doing to ensure they're running an orderly market and that their checks are sufficient for FCMs to be comfortable with the exposure that they may be left with once their clients start trading on that venue.

If there isn't a standard way that they should approach it – and I'm sure they've all got their own version, which will give them an edge and they would say that's why you should use them – then there is room for some sort of utility within the market that would help to map the concept of the FCM's view of what is risk to what the SEF's view of what risk is. In other words, a utility that would ensure that FCMs can post a limit to the SEF which is sufficiently dynamic – that means a limit that can be updated by the FCM as needed based on how that SEF is performing so that if the SEF suddenly start to have issues, an FCM will be able to either pull back the risk limit or potentially throw a kill switch to cut the SEF off entirely. The SEF question is something that the market is looking at very closely at the moment.

ST We don't really know what SEFs will look like but we do have a lot of experience of running electronic trading, particularly on regulated markets and on MTFs. This industry has fleshed out things which are bedrock risk requirements. We know a number of pre-trade parameters are pretty sensible; like the size of a single clip, the number of messages which perhaps you're sending to a marketplace. Those are things which we all agree are sensible to control on a pre-trade basis. We understand that providing firms with drop copies of the fills that they've been delivered from the matching engine over diverse architecture routing back to a firm is highly desirable; so firms can reconcile that data against their own trading records. And although not all of the exchanges have drop copy mechanisms these are things which are desirable and can be integrated into our conformance testing. We should be looking to the regulators to ensure that new designations of regulated platforms, such as SEFs and OTFs, draw on that broad experience. If we fail to do so, we are massively missing a trick as an industry. There's plenty of room for innovation and for clever stuff providing service providers with room for a competitive-edge but this is the bedrock of getting the risk controls right at the base level.

NS Yes, I guess the only thing that I would make sure that people walk away from is that people like to say SEF rules are unclear and we don't know what they'll look like. We actually do, it's naked DMA, right? When you hear a SEF or a DCM or an OTC you should think naked direct market access because that's clearly mandated in the regulation. You have to assume that any client could behave in any way they want. It's like you're given an ATM card that's fully loaded. Is the ATM going to enforce withdrawal limits? These are the things that you're worried about. So, as an FCM you understand the market access paradigm even though the SEF rules aren't final. You have to decide how you're going to enforce those limits, when you can't you're not intermediating the market access and looking at the order on its way to the trading venue.

That's where there are a lot of different approaches, but at the end of the day as an FCM the one area of the rules that we think will be there is that you have the right to look at the risk management capabilities of the venue and decide that they are sufficient to enforce my limits. If they are not, you need some other means to screen orders before they enter that market. So if you were a trading venue operator, you are going to have to think about having the appropriate pre-trade risk controls for DMA clients whether they're doing it through a GUI or doing it through APIs or whatever the market paradigm. What is going to be interesting to see with SEF rules is how aggressive they are in prescribing that the SEF really has to invest in these things versus just sending orders out to the FCM or something like that. But we do know that it is a new world of everyone being in a DMA-like model.

TL One amazing thing is that we've talked about SEFs for the last ten minutes and usually the question of liquidity is the first thing people talk about and it's something we haven't talked about yet. It doesn't seem part of the standardisation discussion so maybe we should leave it out, but I don't think we should because there is an assumption that there will be a large number of SEFs in the beginning and that number of SEFs is going to change over time and you're going to need links to as many of the SEFs that they want to post on. There's a need for standardisation as well to get the links to the multiple SEFs to be standard because the number of SEFs is going to be dynamic. In order to maintain liquidity you need to plug into those SEFs that you want to and not have a long period of time and a lot of heavy lifting to start trading on a certain SEF.

PE At the risk of harping on about the same thing again, standardisation is important here. FIX has done a lot of work in terms of describing what is it that I traded to allow APIs to manage orders at the SEF, but will they all provide bespoke APIs or will they be somewhat standardised?

Our experience with the OTC market is that middleware has sprung up, with various companies providing it, to link up different venues and translate their languages so that customers can have a single pipe that is cheap to own, easy to maintain, and means that they are not stuck with 50 different APIs speaking different versions of FIX or FPML (the other OTC messaging format, Financial Product Market Language.) Certainly, you don't want lots of different APIs that you have to maintain as they are upgraded. That particular API provider will keep giving you new functionality that you may ultimately want, that your traders may want to take advantage of, and there's a huge cost to maintaining multiple APIs. So either it's a standard language that everybody talks or you probably will find the growth of middleware in that space, and, as a middleware provider I'd say that's to be encouraged, but everyone has their own view, of course.

ED If we can move on from SEFs now to the pre-trade risk discussions that you started, Stephen, looking at how we can establish common industry practice, common protocols and so on. Can you talk a little bit about that?

ST We owe it to ourselves to ensure there are generic solutions to common problems. Now, you did ask how, that's really difficult. I don't know how we achieve that, but we do have to achieve it. If we have diverse solutions to common problems then it opens up all the problems we've talked about. Firms will have to develop bespoke expensive processes. Those processes will be hard to manage. Operational risk will increase. Without standardisation we might end up with rafts of controls but all we're doing is increasing systemic risk because sometimes we will not be able to manage diverse systems and controls efficiently. At that point, we're going to have to deepen our pockets to create and manage bespoke systems anyway.

Going on to look at a topical example of kill switches, I think there's general acceptance that having a kill switch at the venue level in particular, and also at the FCM-level – indeed firms implement controls at the firm-level too – is a sensible approach. It does raise the question of exactly what is a kill switch, and are all kill switches born equal. The answer to that unfortunately is that that is unlikely to be the case, and so we do need to look at standardisation once again. It is important to define for example, who can press a kill button (virtually or manually). Who is accountable for the action of doing so? Who has the information to make an informed decision about when that button should be pressed?

Let's take a futures and options firm trading on Euronext Liffe and concurrent trading on Eurex. Eurex has a kill switch. Liffe may have one, one day. There is a mismatch here. Maybe you're long the Schatz and short Euribor against it. Perhaps you have quite big exposures on both of those exchanges although your net exposure may be less if you look at correlations and decide that that is an appropriate thing to do. However, the kill switch may be activated on one of those venues and not on the other because of whatever parameters are defined on each different platform. You go on merrily trading on Liffe and unfortunately your trading activity on Eurex has stopped. What you're actually doing now is increasing your exposure. So there does need to be a common understanding around how these bedrock tools are going to be employed and utilised because without it we are only increasing risk. So it's not that "standardisation is a nice to have". It's that standardisation is essential. Without it, the industry might as well not continue the conversation.

Taking it one step further, and while kill switches are a very hot topic, very popular with the regulators around the world, but actually we shouldn't even talk about kill switches unless we also talk about the post trade control environment. That's because your kill switch is looking at your position and how risky your trading is. But if it's not informed by rock solid post trade information, going back to this idea of drop copies, then really you're missing a trick. A kill switch is a knee jerk reaction to a problem. Providing a meaningful way for firms to actually know what their position is at any given point in time is a good way of pre-empting such problems.

Maybe a firm sees fills coming back when they're not expected; fills that it did not actually anticipate according to its front office records. This is an indication that a pre-trade control should be 'pressed' at the firm level. It prevents the need for building up the risk concentration on a particular venue or across a particular part of the industry. A holistic approach is needed, post-trade and pre-trade need to be working hand-in-hand. And there needs to be standardisation. It's absolutely clear cut and if we can't arrive at that conclusion then we are going to lumber ourselves with massive cost. Perhaps just remember VHS and Betamax to see the cost implications of getting standardisation wrong.

TL There's just one thing I want to add because I think you hit the nail on the head. It took this long to talk about holistic, but you're absolutely right, that's the issue. It's the entire life cycle of the trade and you have so many different parties to it. You have the buy-side, the underlying fund that they're trading on, the executing broker or the FCM, the CCP, the SEF, separate utilities, the SDRs [swap data repositories] and all this. You really have to look at the entire chain and if you don't automate and standardise the entire process, what you have is a great house with great plumbing, but people with buckets catching the drips. That's the issue.

NS We've had our kill switch service in ETDs and FX in operation for about two years now. It's been activated five times across a population of 500 or so buy-side firms. None of those times has been the breach of a clearing or position limit, and the regulations are all focused on this limit. With the exception of a couple of cases, the breaches were where there was activity that the client didn't want to generate that was electronically generated due to a defect in an algo. FCMs are really good at understanding client positions and if they're growing and working with the client it's the technical risks that need solutions like kill switches for the most part.

Managing the risk on an intraday basis is something the industry's done a really good job of and you don't hear of big losses very often. But what we have seen is someone putting a defective algo in and it wraps up a huge position and then there's a loss. So most of the situations we've seen have been the equivalent of the fat finger, and it's across a thousand trading accounts, across exchanges and FCMs. The regulators have not embraced the reality of what the risk is that really needs to be managed, what holes need to be plugged effectively. We're getting there but now there are a lot of conversations around clearing or position limit enforcement on a pre-trade basis where we literally haven't had significant problems to date.

PE Tying those points about the kill switch and the comment about trading across different venues together, it does feel like the risk management across those venues needs to reside with the FCMs. Paul was talking about how clients expect real-time feedback on their trades getting cleared that will tell them the impact on their collateral position and therefore on their available credit line. The key is to have an infrastructure where the credit lines can be monitored such that alerts can be generated throughout the trading day. If it's a runaway algorithm then you don't have very long potentially, but I feel there should be the ability to monitor your client's lines and have a system that can ping out alerts that say 'hey, customer X just hit 50% utilisation; 75% utilisation; 90% – better give them a call.' I definitely think that is the way things need to move in order to control that risk.

"The regulators have not embraced the reality of what the risk is that really needs to be managed, what holes need to be plugged effectively."
Nick Solinger, Traiana

PM One of the things we've done in the listed space is to give clients control of a pre-trade risk layer, independent of our own. How that works is if you've got a black box you can set your limits however you want, as long as they are lower than ours, and that includes price tolerance limits, maximum order size, maximum intraday positions. We can also publish what we call a soft limit alert back to the client. So as long as the client can support that message we can send them an alert when they're getting close to their limit and hopefully they will design their system to not carry on regardless and thus this will prevent them from hitting a hard stop.

We can make these tools available on the client's desktop and that includes their own kill switch. The one thing I'm very cautious of is going too far in terms of what the FCM's responsibility is. We are mainly here to make sure that the client pays their margin at the end of the day and that we pay that on to the clearing house. We're not here to babysit and decide if that model is a good model or is that a suitable algorithm. Obviously we need to make sure that clients understand what they're doing, perform due diligence when we onboard them and make sure that they have procedures in terms of how they test their algos. We also need to monitor our counterparty risk and perform post-trade surveillance for market abuse. But what we're not here to do is to second guess and intervene when we think that they're exceeding an arbitrary parameter. There is a limit to an FCM's role because we don't really know what the client wants to trade today versus tomorrow.

ST A well run firm should indeed be worrying about that stuff itself. When you do due diligence on a new client, and you're taking them onboard, and when you regularly review that due diligence, you'll be looking for certain things. But a well run firm should be able to manage its own margin, should be able to manage its own pre-trade. It should be able to manage its own market risk exposure, and that comes back to the growing need for service providers. As markets fragment the whole process gets more complicated and therefore more expensive. This creates space for service providers to come in and say, 'we'll bear the technological cost and we'll use our economies of scale to deliver those services to the trading firms'. Ultimately, the trading firms are the only ones that definitively have access to all the information about all of their positions and trading intentions. They should have no worries knowing where they traded, where their orders are posted and how positions are split across different clearing houses or split over different clearers. The trading firms should know their position and orders all the time and if they don't then they really should not be trading. That's where regulation must come in.

NS We have this challenge of how to detect a runaway algo versus trading into, say, the non-farm payroll. There are a lot of things that trigger large volumes of orders that are legitimate and there are things that trigger large volumes of orders which are not legitimate. So there's this fantasy that screening orders will protect you from exceeding a position, because knowing what will actually execute would require you to be the best trading shop on the planet to know which orders are going to get filled.

PM You would need to monitor the pattern of a client's open position, fills and working orders, and it's simply not possible for the FCM who doesn't know a client's particular model to understand if that pattern is exactly what they're expecting. Even if the FCM knew roughly what the client was trading there is no way to tell in the case of a deviation if this was intentional or not. All we can do is halt them if they reach a pre-defined lot limit or credit threshold. The responsibility does need to come back to a large extent to the clients themselves.

ED Can I just go back to the point you made, Stephen, around kill switches and the inconsistent approach among the exchanges that you've mentioned already. Are the regulators going far enough in terms of calling for that more consistent approach, and did the ESMA guidelines, for example, help in that process?

ST You don't want regulation to be over prescriptive and that's really what you're asking. The ESMA guidelines I thought were a sensible approach because they weren't prescriptive, but they did encourage industry to come together and create more prescriptive views. ESMA guidance and then the guidance on guidance was actually written by industry. There's no reason why firms aren't involved in these processes and venues and FCMs aren't involved too. All participants should help shape how things look going forward; for example, how kill switches really should be implemented and how they should operate.

It's hard to say that there is a definitive answer to how you strike that particular balance, but I would encourage regulators to step away from being prescriptive and expect industry to colour in the detail. If industry is not prepared to do that because too many people are fighting too many of their own corners and building their own vested interests, well, then I'm afraid we'll have to go back to the drawing board. But at the moment with my naïve hat on I would say that that is the right way forward, and indeed, around the ESMA guidelines that process, while not without its pitfalls, actually worked quite well. So perhaps that is a model which we can take forward as regulation becomes more complicated.

PM It's interesting how the CFTC approached 1.73 because I understand they didn't want to be too prescriptive on how risk limits are implemented. But then by being so specific around give-ups and the unallocated trades they created a bit of an oxymoron because they said, do it how you want, but you've got to achieve this specific model. With everyone doing risk and execution in many different ways it made an impossible problem to solve.

ED So the role of the regulator in determining standardisation is to set out a high-level objective and hope that the industry does the rest?

PM Or at least have dialogue with the industry about what they want to achieve. Then the industry can work with the regulator on ways to achieve that goal before they set the regulations. So if they want to achieve a new goal, such as algo registration, we need to know why they want to register an algo? Is it because they want to check if that algo is performing market abuse? In that case does it really matter what a specific algo it is? It's very hard to define a distinct algo. It is, however, very easy to define a person and a legal entity and isn't that what really matters from a market abuse perspective?

So if there was an opportunity to work collectively and look at industry solutions to regulatory requirements, this is something that we should do more of. CME and ICE end-user registration and the manual order flag are perhaps good first steps before thinking about algo registration. Why not implement that and see how that goes? See if that achieves your aims before you go the whole hog and ask for reams of algos to be registered and tags to be put on trades that probably won't actually make much useful sense to anyone.

ED Stephen, you weren't on the earlier panel so you didn't get your chance to say whether or not algos should be registered, what's your view on that?

ST Not surprisingly I'm going to say that detailed registration of algos is a waste of time. Tagging electronic trading activity is useful in certain situations if you want to identify problems with electronic trades as they occur. That needs to be on a fairly real time basis, then it's useful to be able to specifically know that particular tags relate to particular kinds of activity. But getting a full scale description of what an algo is, that only means something to the person that wrote it or the firm that they're in is craziness. Market abuse is not necessarily a function of speed and if the regulatory community were to go down that path then they need to be conscious of the fact that the emphasis still needs to remain on the intrinsic behaviours in the marketplace. The focus needs to be on behaviours that could develop market abuse, not the mechanism by which orders are placed and speed with which orders arrive at the marketplace.

Question from the floor Is there an opportunity here for the FCMs to get together where you all contributed your own price, you all contributed to this central organisation every day a standardised client ID, how much funds they have with each FCM including their collateral, and that that central organisation could, if you like, create some kind of a real time national margin and credit worthiness so that all of the trading groups, and all of the individual FCMs or even groups within those FCMs don't have the cost of continually trying to calculate and work out the risk of their individual clients?

And I think it will be made easier because I think the EU is going to go down the route that you have in the US where the exchanges have to be able to identify trades down to individual clients, and if that's going to happen over here then real time all of those trades can get pushed into this organisation that the FCMs are running and that it would help to, if you like, standardise your clients. I know that's a different way of thinking about it, also the opportunities for clearing as well, the FCMs have different expertises in clearing certain ones than others, perhaps there'll be a way that even intraday you could all bid for different FCMs client clearing for the end of that trading day, and maybe there's just a way that you guys could centralise and standardise your own client base and your own client base's risk.

PM From an FCM perspective, working in consortia directly with other FCMs is rather difficult, challenging and time consuming. So this kind of indirect approach potentially with equity ownership is another way to approach the problem.

PE Are you saying you plan to use the vendors to do the legwork for you?

PM It's more about efficiency, so vendors have some skin in the game as well as the FCMs. The FCMs have a lot to focus on right now, so it's about having a bit of extra leverage too, not just trying to do it all yourself. FCMs don't have the resources to pull all the headcount together to go off and work on every special project. Because of what's going on in the industry, budgets are tight and headcount is tight. You need help from a third party, another way to give you some leverage, to come up with solutions. Equally you don't want to put all your eggs in one basket in case something doesn't work out. You also want to have your bets spread across a few different solutions and see which one comes to fruition.

NS It's really hard to comply with CFTC rules for swaps without a central utility and the industry is embracing an approach where all orders on an SEF or DCM with swaps will be pre-screened. The futures market is different, the differences in market structure make it very difficult to implement the rules in any way (let via the central utility). A lot of discussion is going on about the right approach, but in both cases I think everyone's stopping short of saying let's centralise the collateral in margin calculation utilisation. That's still pretty proprietary for FCMs, but certainly enforcement of some swaps limits in a central utility is something the whole industry sees the benefits that you raise and are looking at that seriously as a way to both make it easier for clients

“It’s not a bad idea to have some principles on best practice for what to do if you’re developing and launching algos into a live market.”
Paul Marks, Citi

to get market access as well as easier for the industry to comply with the regulations.

PE Looking at the Dodd-Frank reporting legislation on the OTC side, you can see how vendors can provide centralised solutions that help people meet regulatory requirements. In OTC, everyone has to do three levels of reporting on the transaction. They have to do a real-time report that goes out anonymously to tape; a primary economic terms (PET) report, which is an intermediate report, and then a full confirm report. They all have different submission times. So you have to do a real-time report in real-time, your PET in 15 minutes, and then, you might have 24 hours depending on the kind of firm you are to get that confirm report in. This is in addition to all the clearing and reporting from the clearing house and ongoing valuation reporting.

A number of vendors are offering reporting solutions and a number set out to become swap data repositories. These are centralised sources of all that trade information that regulators can then look at, but you can see competition at work there, which comes back to having skin in the game! It’s quite healthy to have a few vendors trying to put together some sort of utility, whether that’s the central kind of limit management hub or whether that’s an SDR or a reporting engine and hopefully the best solution wins out.

ST When we were looking at data aggregation across multiple formats and centralised utilities, ‘Too big to fail’ is the phrase that springs to mind. Yet there needs to be shared ‘skin in the game’, a shared approach to maintaining it. Philosophically it’s a great approach and if we can get towards that, through vendors or through the creation of a joint venture or utility then fantastic, but that might be a pipe dream.

ED It sounds like it might come back to you in about five, ten years time.

ST It sounds a good idea.

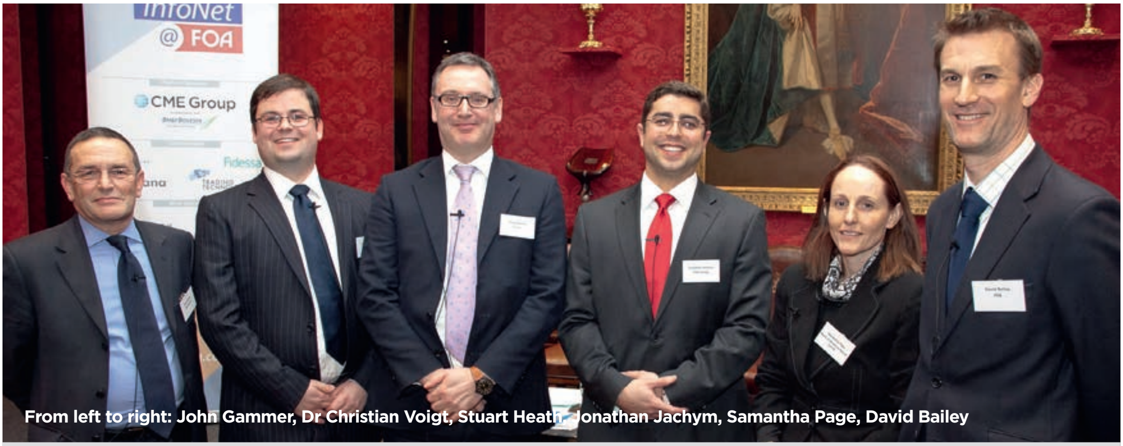
Sam Tyfield It’s a question for Paul actually on the AT-9000, which you raised at the end. Have you guided any opinion from buy-side as to their views on the move towards an AT-9000? What I’m hearing is that there is a suspicion that an AT-9000 standard is going to be... there’s going to be a jaundiced approach, particularly from the US regulators towards that, which is fine, go ahead and get yourselves certified, but that is in no way going to replace what I’m going to stick on you, have you heard anything in addition or in contrast to that?

PM No, to be honest it’s just something I’ve been following loosely because it’s being run out of the US. It has its own website www.at9000.org and they’re already working with standards organisations. It seems to have legs of its own. What I’m waiting to see is where it’s going and what the CFTC’s view of it is.

The other point to consider is what would happen if someone failed this AT 9000 accreditation? What would the consequences be? I’m not convinced of this being the answer to all the regulator’s concerns. But it’s not a bad idea to have some principles on best practice for what you should be doing if you’re developing and launching algos into a live market.

There is definitely room for more prescriptive guidance. If there is a standard then people might say, well, let’s just follow this and make sure we tick everything off on the sheet. Then from an FCM’s perspective if we’re on-boarding a client we can ask if they are AT 9000 certified. That’s something we can practically implement. But we can’t audit everybody ourselves.

ST At least that shapes your due diligence. This has worked in other industries. I mean for those that aren’t so familiar with it and I’m not particularly familiar with it, but ISO 9000 is a standardised approach to dealing with electronic systems in things like aviation and building cars. The consequences of failure are quite dramatic. Well, it has turned out that the consequences of failure can be quite dramatic in our industry as well. So it’s a great discussion to be having even if it doesn’t ultimately lead to designated set standards that people look for routinely, it’s still a great, healthy discussion to have.



From left to right: John Gammer, Dr Christian Voigt, Stuart Heath, Jonathan Jachym, Samantha Page, David Bailey

Panel session 3:
Evaluating the unintended consequences of regulatory reform

Moderator **Stuart Heath,** Eurex

Panellists **David Bailey,** FSA; **Dr Christian Voigt,** Fidessa; **John Gammer,** SEB; **Jonathan Jachym,** CME Group; **Samantha Page,** BAML

DB This event comes at a very timely moment. We are in a period of major regulatory change, and the environment is changing quite significantly. This year will see the changes really start to bite on market participants. Just before Christmas I asked the head of trading at a large investment bank how he was doing in terms of preparation for EMIR. He answered, 'Well, that's next year's problem.' I called him earlier this week and got a shorter answer. That shows you that we are really moving into the period of implementation of reform. We've talked a lot about what reform should look like, but this year we really have to implement, and market participants and regulators have to change the way they do things in a range of markets.

I'd like to talk about how we, and I do mean we, market participants and regulators, can work together to best manage our way through the process of change, and the changes that will bring to the markets we operate in. It's vital that we work together, that we do navigate our way through this change because the markets we're focused on, securities and derivatives markets, are vitally important as a way in which capital can be efficiently allocated and risk can be better priced, transferred and managed. I'm sometimes asked why we are trying to close these markets down. But that's not the case. As regulators we've got the best interests of markets at heart. What we're trying to do is make them work as efficiently and safely as possible.

We've discussed at length the issues that the financial crisis raised. Things like a lack of transparency to regulators of where risk existed; how risk was being priced; risk management not keeping up with the pace of innovation of new products, even with respect to basic operational practices such as the timely confirmation of trades; the highly inter connected web of exposures between market participants meaning that markets seized up because people didn't know who was exposed to what, and who, and how much risk they were taking trading with certain counterparties.

The process of global regulatory change has included a huge variety of initiatives. Things like the G20 initiatives on OTC derivatives, rules for systemically important financial institutions, work on financial stability, IOSCO, Basel, CPSS, etc. And that's before we get to the regional level. In Europe we've seen a huge range of initiatives such as the focus on creating a consolidated Eurozone banking supervisor. And that's all been set alongside UK regulatory reform where we're changing the responsibilities between the FSA, the Bank of England, the new Prudential Regulation Authority and the new Financial Conduct Authority.

Other things have come up while we've been embarking on this process of change. Even over the last 12 months we've been hit by the Libor review and also concerns over potential mis-selling of interest rates swaps to retail consumers.

So while we're trying to hit the deadlines for regulatory change the market keeps moving. All of the changes have been heavily debated over the past few years, but as we move into 2013, we're moving from the discussion about the framework to the crucial phase of delivery and implementation. Dodd-Frank rule makings are coming into effect. Some came into effect last year. Last year in Europe we had the short selling regulation come into force, EMIR will start to bite this year, and then further down the track we've got the changes due under the Capital Requirements Directive IV (CRD IV), the review of MiFID and MiFIR, the Market Abuse Directive, and then from 1 April we'll have the new domestic UK regulatory structure in force.

Do we know what the implications of these massive changes will be? We know many things, such as there's going to be much greater use of central clearing, especially in derivatives markets. We know a greater use of organised trading venues will be forced upon the market. Firms engaging in securities and derivatives business will certainly need to have more capital and collateral and that means business models will have to adapt. We'll have to see what happens to those that don't adapt. Firms will have to get used to greater transparency and a greater cost of doing business.

We'll also see new businesses continue to evolve. For example, several firms have said they're going to start trade repositories for OTC derivative markets. We're seeing firms come up with innovative solutions for collateral management and other new initiatives.

Another aspect is that regulators, if we get it right, should be better informed and have better quality information about where risk lies in the system, and a greater ability to supervise market participants. Markets should be a better place and regulators will have a more effective view on them. We'll be able to make sure they operate more efficiently for all market participants. But we shouldn't be blind to the fact that the impact of change could also be that we add new risk to the market, and it would be unfortunate if we didn't react to new types of firm coming to market, possibly bringing new issues and risks. There have been various initiatives looking at issues such as shadow banking and new forms of risk arising in capital markets.

"New businesses continue to evolve. For example, several firms have said they're going to start trade repositories for OTC derivative markets."
David Bailey, FSA

We should also be clear that while we know some of the answers about what markets will look like, we don't know all of the answers. Not all the rule making is complete, not in the US, the first movers, but also in Europe, we haven't got all the rule making finalised. Not all of it has even been published for consultation. For example, we don't yet have full clarity over the client clearing models that are going to be available or the exact rules for margining for non-cleared derivatives. On this last point there's great anticipation for the work that Basel and IOSCO have been engaged upon for the past year or so.

Then there's the crucial issue of how rules will work on a cross border basis. We've got proposals from the US while Europe has held its rule-making back to try to get agreement with global regulators on how we should approach application of rules on a global basis.

Because of this we can't yet say what the overall impact of this huge range of regulatory reform will be. But there are things that we can be doing to get ready. We see firms that we consider best in class in certain areas already making huge strides towards getting their business models and their businesses ready for implementing the changes. We'd expect firms to be considering the capital implications of the business that they do under the new regime. And looking to answer questions such as: How will the cost of their business change? How will they access trading venues or central clearing for the business that they want to do? How will their clients and the infrastructures they use be impacted?

Many firms have been engaging with us for some time on rule makings and actually giving us detailed information on what it means for their business model, so we can make sure that where we have the ability to calibrate the rules we can do so in a proportionate fashion. These are good steps that we encourage all firms to follow, but also we are doing as much as we can to help the market get prepared. We know that the more concrete information we can put into the market about the exact details of change will help firms prepare. We continue our heavy agenda of engagement with global regulators on cross border application of rule makings, and we're pushing for greater clarification on rule makings where possible. We've seen FAQs come out of the European Commission on EMIR and we're expecting to see more from both the commission and ESMA on that.

The FSA has set up detailed web pages about all the major initiatives that we're undertaking from a European perspective. We have implementation pages on the short selling regulation, on EMIR, CRD IV and MiFID. We've been out already benchmarking firms against the requirements for EMIR and short selling has already been implemented. We're questioning the firms that we expect to be getting prepared to make sure the market as a whole is doing what it can to implement the process of change smoothly.

So in summary, we've come a long way since the financial crisis and we've done a lot of talking about the reform necessary to address the concerns identified. Now, we're moving into the period of implementation. It's not too late to start preparing, and we would expect and encourage firms to prepare as much as possible. If there are any authorised firms not getting themselves ready for regulatory reform, when reform starts biting we won't look too kindly on them, but I do believe that once we've implemented the change the financial system will be a better place to do business.

SH Thank you for that insight on the process and for answering probably the most pertinent question, 'Are you trying to close these markets?' I'm very glad that the answer was 'no'.

We've got EMIR biting at the moment, we've got MiFIR and MiFID coming in Europe and Dodd-Frank in the US. All of this is a significant burden on the market and to FCMs in particular. And CCPs, for example, are working on things like asset segregation. The first question I'd like to ask is, 'What is the cumulative impact of all this new regulation, especially with regard to operational repercussions?'

JG There are some things that remain opaque but we certainly understand the main things that we have to do. From an operational perspective the key area that we're focussing on is risk management. This seems to take up most of my time. The other topic is that there are still major CCP and market infrastructure upgrades taking place at the same time as our focus is on the changes we have to plan and implement for regulatory purposes. Fortunately at SEB we have a wide range of skill sets in risk management compliance to support us. From an operational perspective I would say that we haven't seen much in the way of change so far, but we are going to see a torrent during the course of 2013. As an industry, we've exhausted an awful lot of brainpower and haven't got anywhere particularly fast, but we know what we have to do. The main thing is to make sure we've got the resources to react because there will be some edicts likely coming towards us that we'll have to react to at fairly short notice.

SH Sam, what is the impact, not just on your own business, but also on your client base – and what are the costs involved?

SP Obviously there is a big impact on clients. We are a client driven business and as an FCM we are there to provide clearing within the proper risk management models for our clients. The challenge going forward is a lack of clarity from the regulators. We've seen a flurry of no action letters, specifically in the US. Speaking on behalf of my US colleagues, we have a clearing 'go live' date that actually hasn't moved, but the definition of who would be caught by that has changed even, in the last couple of weeks. Now, perhaps there should have been an expectation that that would happen and clients could almost expect to be caught by these rules and perhaps there was a small hope that this would not happen, but it's just that they didn't actually know it was happening so how could they be prepared?

That said, as an institution we are prepared and we can provide a solution, but ultimately, it has to be the clients who engage and actually go live with these new processes and systems. Clearly BAML wants to be at the forefront of regulatory compliance. We have a very strong risk management model and are ready to go, but clients also have to be ready and able to start effectively. We are there with the door open. It's a very challenging time for clients.

Extraterritoriality is a really big issue. In addition to the US and Europe there's conflict, of course, with Asian jurisdictions as well. It's a very opaque, frustrating, confusing, challenging situation and this all impacts on costs, for end-users as well as us.

JG One thing we've observed, particularly among buy-side customers, they are now realising that not only will there be increased costs from FCMs and GCMs, but there's also a big investment they to need make in terms

"Extraterritoriality is a really big issue. In addition to the US and Europe there's conflict, of course, with Asian jurisdictions as well."
Samantha Page, BAML

of risk managing their business in a way they haven't had to contemplate before.

SH Picking up particularly on the costs and operational effort it's going to take to implement the regulation, do you think that there's only room for larger FCMs to undertake this for a complete client base? There was a recent Tabb report which said there would likely be a reduction in the number of FCMs who can provide such services.

JG The answer is, 'Yes.'

SH Jonathan, do you think there's increased concentration risk with fewer FCMs coming in to the market because there's only a limited number who can bear the cost?

JJ We held a meeting with our global clearing services this week and this was the primary topic of discussion. We've seen the Tabb report, and when you look at the timelines for what's coming along, we may have underestimated the time and resources it will take to go live. There are indeed the capital and operational issues, but looking at the ramping up of regulatory change in Europe throughout this year and with mandatory clearing coming in 2014, if we look at the preparedness for clearing from Europe's perspective, for example, I'm constantly surprised at the breadth of the spectrum of preparedness. Larger clients are ready to go, but when you talk about things like client segregation models, the readiness there is not up to par, we have still a long way to go. With respect to how much value market participants will put on these additional services, only time will tell in terms of how the market shakes out.

SH David, is the potential concentration effect being monitored? Are CCPs also being monitored, because let's face it they have to be ready before anybody else?

DB CCPs are indeed being monitored and we have been working with all UK CCPs on their preparedness for implementing EMIR, including how they are facilitating access to services and client clearing. It's an area we're very focused on. We have a significant programme throughout the year to ensure we have a smooth transition into the new regime.

In terms of broader preparedness across the industry, it's something that we are watching. It's more difficult for us to monitor, but we are spending a lot of time with market participants to make sure they are prepared. We've done a number of road shows where we've had participants coming along to discuss the issues they're facing in implementing EMIR etc. As participants start to set up their operational processes and make the changes they need to, we do want to hear about the issues they encounter. It's very helpful in shaping the rules and how we expect people to implement them. Our door is open so we can hear about the challenges.

JJ In Europe, maybe the top 500 clients are taken care of, but it's really from that top 500 to the top 2,000 where you are concerned. The road shows we are doing for CME Clearing Europe and our new CME Europe exchange in the coming months will be a good litmus test to see which clients are ready, who's not, and what needs to be done, and to see if that concentration risk is real.

SH On the positive side we should also ask if there are opportunities for new entrants. Is there, for example, opportunity, through the infrastructure and technology of the new SEF and OTF platforms, to provide solutions to a lot of these problems?

CV What you see at the moment is a fundamental change in market structure. Especially with derivatives and the introduction of OTFs there are a lot of new changes when you consider that most of the OTC derivatives trading was 'voice only' and a lot was done manually. We are now moving into a more electronic world with a new regulatory framework. This will definitely create opportunities for small, nimble firms to create their own little niche.

We have heard a lot about concentration risk with only the big firms making it. The Tabb report's arguments are very valid, but the same things were being said 20 years ago about small firms being pushed out of the market. There are massive market structure shifts, which can only benefit the smaller, more agile firms. They have a real chance and shouldn't be ignored.

JG Personally, I see no possibility of any new entrants coming into the market, when you consider how much firms like Sam's BAML have invested over the last 20 years, in terms of memberships, default funds, technology, infrastructure, in order to offer global market coverage.

This is not an environment in which somebody should be saying 'If I build it and they will come.' That's just suicide as far as I'm concerned. We are in an environment for both listed and OTC derivatives where we will see the top 10 to 12 banks dominate, and not necessarily just as a result of new regulations. That trend was starting to emerge as a result of competition just before Lehman happened.

If you look at the CFTC-registered FCM list the number has come down from around 180 to sub 100. If you add in the new costs of regulation, I see no incentive for any firm currently not competing in this space to say 'I want to be in that space, I want to be a global player'.

DB Would that mean a worse outcome for clients?

JG Not necessarily, but it does bring us back to the concentration question. What I see happening is a small number of Tier 2 institutions offering services to clients who are not necessarily attractive to the 10/12 dominate global players, due perhaps to low volume, low income, fees or risk profile.

SP To begin, there may be a concentration into a few larger clearing members. With the requirement to clear or execute at a number (even a small number) of venues and the increased cost that entails, added to having to hold increased capital against that risk, for both sides plus our own positions when we're trading for the clients, we will get to a point where we will not be able to allocate out to anyone else, however big or small they are. You'll get to a point where clients will be unable to find someone to take that risk and manage it on their behalf. Ultimately that could lead to more innovation in products or technology to provide alternative solutions or even new entrants into the clearing space in some other form. Wherever there's an opportunity there will be alternative products that will be provided to these types of clients.

"I see no incentive for any firm currently not competing in this space to say 'I want to be in that space, I want to be a global player'."
John Gammer, SEB

I agree with, John. The barriers to entry are so huge that you won't see any new big clearers for some time unless some of the big Asian banking institutions become more global. Some end users may have to change the products they have been using for some time to manage their risk. That leads to opportunities for product providers, whether they are wrappers or alternatives, either regulated or unregulated products. The worry is that you might push clients into a shadow banking system, or whatever, outside of the regulators' remit. You might end up with an over-regulated central system, with a lot of business happening outside it, so all you end up doing is pushing the risk elsewhere. That's my concern.

DB We're very focused on looking at any new risks that are arising and on competition. The whole thrust of MiFID and the MiFID review is to promote competition in the UK. After 1 April we'll have the Financial Conduct Authority with a specific objective set down in legislation to promote competition where it is in the interests of consumers.

I am really interested in what better competition looks like. Does just having more firms mean better competition, or can you have fewer firms and still get a better result for clients? We've talked a lot about clearing members but clearing houses are a different prospect and we need to look at the regulatory requirements for them. They're pretty tough requirements and they should be. These are systemic institutions, centralising risk. The regulatory and capital requirements are strict, yet, if you look at the number of clearing houses that are coming to market or the number of new infrastructures more generally, including CME's plans to launch an exchange, it is worth asking does having more firms actually mean a better outcome for the clients and investors?

JG Fewer firms, more firms I don't really think it makes a huge amount of difference. Let's look at FCMs first of all. Smaller Tier 2 firms may have to enter into strategic alliances, acting as feeder firms into the bigger FCM/GCMs for clients the top 10/12 don't want to take on directly. That provides a service to those clients that the big 10 or 12 don't want to take on, allowing those clients the opportunity to manage their risks.

As far as CCPs are concerned it will be very difficult to create a new CCP. We have very good global CCPs which worked through the Lehman default during the financial crisis superbly. No one can really fault how the CCPs managed defaults in the past. I think some of the comments, sticks and stones that have been thrown at the CCPs since are unfair.

SH To come back to what Jonathan said regarding clients and the top 500 that will be the ones that have access to the markets generally. Do you really believe that's going to be 500?

JJ Just looking at the US experience you can understand how quickly some of the unintended consequences can arrive. On 12 October when the swap definition hit, we were sitting in London running the risk of a major market disruption in energy. There was very little communication until the last minute.

It was 5 o'clock Eastern Time that we got notice of it. That is a really good example of the spectrum of preparedness. Again, you had major market participants that were ready, that were anticipating the need to move from SEFs and the OTC world if they wanted to move to futures. But there was a significant portion of the market that wasn't.

Then came the flurry of no action letters. How do we even define what a 'US person' is? Relief was granted to some of the energy markets. That's one area of implementation we want to look at and avoid moving forward. But, as David said, 2013 will see a lot of operational implications from the US rules coming on line and EMIR is here, as is reporting. It will be really tough in terms of that operational implementation.

DB Jonathan mentioned a flurry of 'no action' letters. The US regulators have the ability to sign these in certain cases. In Europe we cannot issue 'no action' letters. European legislation is binding and the dates are binding.

SH Christian, are there lessons we can learn from MiFID I?

CV There are many lessons to learn from MiFID I. One of the most important is about regulatory divergence. MiFID I created a level playing field across Europe so that a French company can now compete with a UK company and they can all trade in the Italian market. This created a lot of efficiencies.

Looking at the regulatory landscape now I am a little concerned, especially in the European context. We're talking about a German HFT Act, the French Banking Bill and the Italian Financial Transaction Tax. That doesn't sound very much like one European level playing field.

Secondly – while I understand that national regulators and politicians want to react to markets quickly because they need to satisfy the demands of their voters – there is so much divergence within Europe at the moment that this is really creating a major problem. We need to go back to the reasons behind MiFID I where we said, if we create one market in Europe this will deliver benefits for everyone.

DB There was an interesting piece in the *FT* this week by Alberto Giovannini on this topic. It said we need to open up markets to true competition across Europe and that an important aspect of this is opening up infrastructures to competition. That's exactly what some of the access provisions in MiFID and EMIR are moving towards, providing clearing houses access to trading feeds so they can compete with other clearing houses and providing venues with the ability to compete with each other to access clearing. I'm very interested to hear from Stuart and Jonathan, as two proponents of vertical silos, on their view of opening up infrastructures to competition.

JJ Open access is great for OTC and we fully support it. A fierce debate is going on right now. In the US open access exists for swaps, but we haven't seen the impact yet. There is a lot of talk of competition. Market participants are asking – am I going to be a SEF, or am I not? We probably won't know until later this year, but in terms of operators the markets are much different. Securities markets are different from derivatives markets and OTC is different from listed futures. There is a lot of talk about 'futurisation' and now that there's been a sharp focus on what OTC regulation looks like, people are comparing it.

ETDs have one type of margin and OTC has another kind. Where is there an imbalance? Is one fair, is one favouring the other? They are completely different products, when you look at the characteristics. Particularly from a risk standpoint, the regulation should match the risk profile of the product. That's not to say in two or three years' time that some vanilla OTC products will be cleared and then eventually exchange traded, and that risk profile might not look more similar to something like an ETD that requires a one or two day margin period of risk. That execution component and how these lines are blurred is definitely going to be an interesting part of 2013 as well.

SH Competition is coming. There's competition in OTC clearing and that will probably extend into OTC execution. But I agree that derivatives are not directly comparable with the cash markets. The risk profiles are different, and as a clearing house you rely on clearing members to provide the default solution to these markets. If you can get them to agree the same swap curve I'd be very impressed and the same for the CCPs.

We've talked about 'futurisation' briefly, but if you think about interest rates and swap clearing in particular there is competition coming on that. Looking at the potential for concentration risk with fewer firms and fewer clients having access to clearing, the amount of costs involved in changing the infrastructure would suggest that this is not the market for new entrants in either clearing or in trading. But we also are hearing of new entrants in swap clearing.

We're seeing a divergence not just between the US and Europe, but within Europe itself. What do you think the impact is there? Do you really think the regulators in Germany are aware of the impacts of HFT laws, for example?

CV I hope they are aware. What concerns me is that looking at the German HFT Act, a lot of the issues are also raised in MiFID and even mentioned in the ESMA guidelines. The problem is the MiFID II implementation timeline is a little way out. It looks to me like German politicians were unwilling to wait. They decided to front-run European legislation, and this is really hurting the industry because, in terms of project management, it messes up the whole calendar. All of a sudden you have to move implementation planned for the end of 2014, to maybe 2013. You have to do this because the German HFT Act to be enforced this summer has an implementation period of six to nine months. So any careful planning you did because you followed the advice of other European regulators is wasted. You worked out your implementation plan for the next four years and allocated the right resources for each project to be legally compliant and then it is all thrown to the wind. This makes it really difficult and it seems that there isn't a need for a MiFID II anymore because there's too much work to do in advance.

JJ For me, it's almost intended consequences. I've compared the transaction tax idea across the globe in different jurisdictions. The Italian impact assessment said there could be a reduction of derivatives trading by 80%. They are not going in there blindly, it's an intended effect. The French FTT, Italian FTT, it's all music to the ears of our London exchange CEO, because that has the potential to drive arbitrage faster than any new regulation.

CV The Italian Financial Transaction Tax is a very good example. On the one hand, the level at which the tax is levied is really high, and participants might really dislike it, but the really painful problem is that, even after five days of studying it, I couldn't explain to you how to estimate it. It's not so much the level of the tax, it's the uncertainty around the process.

Even doing the supposedly simple maths is just too much. This is something we really shouldn't need to discuss. If the aim is to reduce derivatives trading by 80%, why not just do one simple tax and make it a really big number, but please don't come up with a complicated process around it.

SH We should touch on the difference between Europe and the US, particularly with regard to the timelines. David, how well is the global co-ordination going? We've seen the disparate timelines, but are the intentions at least co-ordinated?

DB I can understand why market participants would ask that question. We are engaged in regular dialogue with our colleagues, not just in the US but also in Asia and the rest of the world. There's a lot of change going on elsewhere too. In early December we saw a statement of principles put out by global regulatory authorities on co-ordination specifically with respect to the application of cross border rules. That showed a definite intent to harmonise, but we're all working

"German politicians... decided to front-run European legislation, and this is really hurting the industry... it messes up the whole calendar."
Christian Voigt, Fidessa

within different legal frameworks and political contexts.

We will harmonise as much as we can. Does that mean that we'll have perfect harmony and a one for one rule mapping between jurisdictions? Probably not, there'll be some differences and I'm sure it will create some opportunities for arbitrage, but what we're really looking to do is end up with the same regulatory outcomes on the big issues and the same level of risk mitigation and competition. The intent is there, now we've just got to deliver.

SH Has this co-ordination been more of an ongoing process or has someone raised a red flag and said let's all get into a big room and discuss this?

DB There are a number of issues in the legislation that various regulators are dealing with. Dodd-Frank was finalised over 18 months ago, and there are certain constraints that the US regulators have when operating under Dodd-Frank. There is only so much leeway they can give in terms of what firms have to register and how certain rules can be written. Likewise from a European perspective, ESMA and the authorities that contribute to all the work in ESMA can only write rulemakings where legislation mandates that we write rule making. We have only so much flexibility and that will constrain some forms of convergence and co-operation.

SP As significant participants in this landscape, BAML understands there may be some conflict. So long as it's made clear that there is best intention to choose a relevant regulator and, therefore, be compliant in one regime – whether it's called equivalence or substituted compliance – then there can be less conflict. At the moment there is still a very serious concern around being conflicted between regimes, having to do what is necessary in whichever jurisdiction you're caught can be duplicated or possibly 'triplicated' and that can be very challenging.

DB That's a good point. If you look at some of the public comment letters that the FSA and a number of other authorities have filed during the CFTC comment periods and some of the letters that finance ministers and our own chancellor have sent to the CFTC, they typically addressed that point. They look for an approach based on equivalence or substituted compliance making sure that market participants are meeting acceptable rules. But they don't have to be the domestic rules, providing they are rules that deliver equivalent outcomes.

JG Have you seen any practical reaction to the October letter from UK, France, Japan, EU to Gary Gensler? It was very open, very ministerial, but nonetheless used mild rebukes and reminders.

DB These things do not go unnoticed. We are co-operating very closely with the CFTC on getting to an outcome that enables us all to deliver the objectives we have within our legislative context.

JG But it took a very public letter perhaps to move it forward.

Question from the floor I'd be interested to hear more of what you think the unintended consequences of this will be? And how do you substitute compliance when US regulation is so far ahead and there's nothing to substitute it with yet?

DB They do matter, and I guess we don't know yet exactly what those consequences will be because we haven't implemented much of the legislation. Even in the US the CTFC are only just over halfway through their rule makings and the SEC are just over a third of the way through theirs. Until things are fully implemented we don't know what the unintended consequences will be, but I'm sure one will be that certain business will move into other, potentially unregulated forms. It's absolutely not our intent to push risk outside of the regulatory perimeter. It's to make sure risk is appropriately managed and markets work more efficiently for market participants. So anywhere where that is not the outcome achieved will be an unintended consequence.

With respect to substituted compliance and how the US regime can work if there's nothing to compare it against, it comes down to timeframes for implementation. We need to harmonise those. In a number of instances the requirements in the US have been pushed back, for example with the non-US person registration at the end of 2012, where even non-US swap dealers had to register. But most of the requirements aren't currently binding. By the time they are, European legislation should be enforced. ESMA is right now working on equivalence assessments. There does need to be an appropriate implementation. We'll see how that maps out.

JJ Regarding unintended consequences, there's a real probability of regionalisation. We've already seen it with the CFTC's definition of a US person. That had an immediate effect, particularly on asset managers in Europe, who may have had a couple of US investors in a fund, and who would now automatically have to register as a CTO or CPO which would immediately bring them into the definition of a US person. That then leads on to them having to satisfy their clearing obligation by clearing through a DCO.

It's the 'waterfall effect' that really has the potential to bring these participants into Dodd-Frank. We've heard many of them say they don't want to come under Dodd-Frank. In fact if they are able to adjust, maybe through corporate affiliate structures, they prefer to do it in Europe, under EMIR. They are looking for that regional solution.

We're doing that equivalence assessment ourselves, with a clearing house preparing to register in the EU as a third-country CCP. We've been going down the list of Dodd-Frank requirements and there are instances where Europe has a more conservative approach, and others where the US does. Should that be a barrier to facilitating cross-border business? We think not, and we're hoping that regulators resolve this discussion as soon as possible.

SP There's an additional problem in that if you choose to be outside the US you are now limiting your counterparties and therefore, your access to liquidity. You may be getting worse prices and ultimately there are more associated costs for end users and indeed all of our own pensions will go down! Until it's made clear that as long as you are compliant in whichever applicable or acceptable regime you will end up with all sorts of limitation and that leads to increased costs and confusion because you're reducing your number of counterparties by all the biggest banks in the world.

"We've been going down the list of Dodd-Frank requirements and there are instances where Europe has a more conservative approach, and others where the US does."
Jonathan Jachym, CME Group

This may indeed not satisfy best execution requirements because you cannot access where the real liquidity is.

Question from the floor We keep on hearing about equivalence and substituted compliance as if it's going to be a solution, but substituted compliance is I believe only on a transaction level, not on an entity level, so there's a limited scope for that. This is the first time I've heard that we might have equivalence assessments in place in time for the implementation dates.

So over the next 12 months we're going to meet a number of hard implementation dates without any equivalence assessments or any solution to the substituted compliance situation. Even though we don't have 'no action' letters it would be helpful if regulators said that the focus of compliance is going to be on people that hadn't made any efforts to comply. Even if it's not a formal 'no action' letter, the industry does need to hear something about flexibility in implementing a harmonious regime.

DB Of course, we will seek to implement in a proportionate and effective manner. .

SH I'd like to move onto Basel III, CRD IV and the potential implementation of that. In particular, what are the consequences on the markets and the major dealers? How does it economically impact the larger dealers?

SP I actually sit within BAML in the broker dealer clearing entity, so from a corporate enterprise perspective, I can probably only give a personal opinion.

I should add that we know American banks are actually working towards updated Basel regimes.

However, clearly the impact has the potential to be enormous because capital for banks is going to be more expensive, held for more things at higher levels and hence will possibly increase the cost of funding for clients. On the other hand, we are listed companies with shareholders' requirements. In addition, we work within very strict risk regimes and I suggest that costs for regulatory and risk compliance will be far greater than previously. The fact that there remains a lack of clarity, at the same time that we have an enormous number of regulations coming, regionally, domestically and internationally, makes it enormously challenging. Banks will have to pass costs back to clients because as I referenced we work on behalf of our shareholders. It has been recommended that we should again recognise the real reason for a banking industry, and start to look at protecting it, rather than making it uneconomical to do business, for example to provide funding for companies that create jobs and manufacture products.

SH Another question on increased cost is, 'Are the top 2000 companies likely to continue to trade if they can't trade OTC swaps?' And from there, 'Will futures take over, will there be hybrid innovations, or will there be technological solutions to combine all of these on one platform and cleared through multiple clearing houses?'

CV Technology certainly is an important factor because you can create a lot of cost efficiency. However, it's clear that this is not the only way forward. We also need a discussion on how to structure products – how can I structure my offerings to provide them in a cost efficient way? It has to be a dual track in order to make the transition for your clients as simple and as painless as possible.

SH That suggests you're going to have to have a lot of fund managers being far more active in their execution management and using systems to tap many pools.

CV Exactly. That would be one way forward.

SH Let me come back to the 'futurisation' point. We've mentioned transparency as being one of the key goals of the new regulation and part of this is reporting. Everyone will have the obligation to report to a central repository. However, the rules for that aren't quite so clear. Europe seems to be far more open about who we report to. We report to anyone who wants to be reported to. There seems to be a bit more of an argument about that in the US.

JJ The decision to launch the SDR probably came a little later than we wanted but we view the clearing house as the natural home for data. There is a question if this thing is going to make any money. In Europe there are multiple potential trade repositories, just like we saw at this stage in the US. We very much wanted to report to our own SDR. The timing was the biggest issue. ESMA has stated that we're not going to have a discussion here about any competitive issues. Operationally, one of the main differences between the US and the EU is that Europe lets the ETDs report as well, which is going to have some operational challenges. Many questions are still outstanding.

The FOA has done some great work to get the industry to provide that input. Frankly, it's there in the legislation, but the regulators don't really have a good idea of what the path forward is when you get down to some of the nuanced details of these reporting fields. TRs are supposed to be registered by April and will go live for rates and credit in July. I don't think that timeline will be met but there will be some flexibility. Hopefully we'll resolve those issues before that requirement clicks in. Otherwise, what's the point of having this requirement if the data that's coming in isn't readily utilised by the regulator?

SH Is there a significant operational impact on the data reporting?

JG I don't yet know because it's somewhat unclear. In theory it shouldn't be any more complicated than the transaction reporting we go through at the moment. Certain market participants such as brokers cannot deliver information regarding a client's net position and/ or collateral, so that is an impractical current requirement.

SP We're already fully compliant in the US and have been regulatory reporting for many years so we're bringing our project team over from there. We now are required to also do real time reporting and clearly there are differences in these requirements. The logic of requirements to double side report does not seem clear. It just seems very odd, and what would you do with all that duplicated data when you got it anyway?

SH David, the regulators are going to get a significant amount of data. What are they going to do with it?

DB We're very conscious that when we get data we'll be expected to look at it and use it. But looking at the Warehouse Trust, it has been housing CDS data for

"As we've seen... there is public reporting, which is highly used within the industry. That can be helpful in terms of overall transparency as well."
David Bailey, FSA

several years and has been a great source of information for regulators in terms of identifying pockets of risk and market evolution. We would seek to use new trade repository data in a similar way, but as you add new asset classes, new challenges come in terms of what the information is likely to tell you.

For example, understanding positions from the vanilla CDS data is a relatively simple process of adding up the notional, but when you talk about interest rate swaps the notional is not the only information you need to determine what the risk of the contract is. So we have to be more sophisticated in how we use that information.

A proliferation of trade repositories is also going to be challenging. We're going to have to merge data, get it in the same format and combine it to get the whole picture. We can get through the challenges ahead and get some really useful data. It won't only be useful for regulators. As we've seen from some of the existing trade repositories there is public reporting, which is highly used within the industry. That can be helpful in terms of overall transparency as well.

Question from the floor The way that the clearing obligation is designed in EMIR is that it comes from the CCPs reauthorisation. Of course, the CCPs are currently working on when we will be making that application. However, there might be some indications coming out before then as to what might be mandated, and also the particular nuances that are mentioned in the EMIR text about potential phasing, the categories of counterparties, and the time to maturity. That would be of interest to participants and CCPs.

DB The process is still being developed, but as you say, the main way the clearing obligation is expected to work in Europe is as CCPs get authorised the contracts that they clear will get notified to ESMA, and ESMA will then make a determination as to whether a clearing mandate is relevant or appropriate for those contracts. There's a whole set of criteria that ESMA have to consider in doing that. So a good starting point would be to look at what is currently cleared, and a sub-set of that is likely to form the first wave of things that comes subject to the clearing mandate. Another good place to look would be at the contracts the CFTC have already consulted on with respect to clearing mandates from a US perspective.

Again, in the interest of harmonisation you can see that Europe will have regard to those contracts as well. Those are the areas I would look at, but ESMA does have to go through a consultation process as part of determining the clearing mandates. There will be notification ahead of a clearing mandate being implemented.

Regarding implementation phasing, ESMA and the European Commission do have the ability to phase according to category of counterparty. You can see that there will be certain types of participant that we would look at and we would expect to be clearing in the early stages of a clearing mandate. For example, the main dealers will probably already be clearing many of the trades, and therefore, it would be reasonable to expect that regulators will focus on them first, and then look to broaden that out. Obviously, in making that determination, ESMA will draw on information from clearing houses and market participants around what it is possible to clear and how easy it is to access clearing.

I wouldn't expect a clearing mandate to be placed on a product for all types of counterparty where access to clearing that product is in practice restricted. That's one of the criteria that ESMA will consider. And with respect to ESMA we should be very clear, ESMA as a pan-European authority has a limited staff currently and much of the work is done by national authorities operating within the ESMA context. So it is national authorities, including the FSA, that will be heavily involved in this process, and who will be talking to market participants about what it makes sense to put a mandate on and what it doesn't.

Question from the floor Now that you'll be getting all this data don't you feel that when the next crisis comes, all the data that would have predicted, controlled and should have stopped the crisis will now be in this huge data warehouse. How are you going to manage the expectations of people that say, 'But you knew all of this'?

DB We had to be very careful to request data that we can analyse and expect that we could draw conclusions from because you will indeed be able to point to a huge morass of data and say if you spent ten years delving through that, you could have told me that was going to happen. Managing expectations is going to be a real challenge.

Utility clearing in Europe: Time for another look?

Gary Delany, director of European marketing and education at the Options Industry Council (OIC), considers future prospects for the horizontal model in Europe

Utility or 'horizontal' clearing, where one clearing house operates for several exchanges, delivers many benefits. It offers economies of scale from processing trades from multiple exchanges. It offers capital savings from margin offset. It offers new entrant exchanges access to existing open interest, thereby potentially benefiting both the new entrant and the prices quoted on the existing market.

Perhaps most importantly it enables participant exchanges to focus on the development of their business and product innovation without the distraction of clearing. 'Distraction' may be the wrong word. For existing 'vertical' exchanges (i.e. exchanges that own their own clearing house), clearing is certainly an important revenue stream.

Seen in the wider context of developing a market and bringing in new participants, however, vertical clearing also has drawbacks. A common lament in European markets is the lack of margin offset between clearing houses and thus the higher cost of financing positions. Higher cost means lower participation, thus lower volumes, wider spreads and higher costs to market users.

The US equity options exchanges have been using a common clearing house ever since multiple exchanges were established, when the US Securities and Exchange Commission (SEC) engineered the spinoff of the OCC from the Chicago Board Options Exchange (CBOE).

In Europe, the evolution of clearing has been different. Exchanges trading equity options either developed initially as standalone exchanges (which would in turn become part of existing stock exchanges), or as new divisions of existing exchanges. In both cases, exchanges offered clearing via their own clearing arrangements.

MiFID I introduced more competition by allowing the development of multilateral trading facilities (MTFs), that were keen to offer new business models and that are now starting to address the development of options business and the challenge presented by clearing.

Fast forward from MiFID's implementation in 2007, to the present day. With the failure of the proposed merger between Deutsche Börse and NYSE Euronext in 2012, ICE is acquiring NYSE Euronext and seems likely to divest itself of the continental European equity market side. Depending on the outcome there, would the emerging entity still favour a vertical model?

There have also been developments at the London Stock Exchange (LSE), which acquired 60% of MTF Turquoise in 2009. Turquoise has spoken of its ambition to develop its equity option business and in 2011 stated its intention to offer margin offset with other equity option exchanges that were also 'pro competition'. Since then LSE has agreed to take a 60% stake in clearing house LCH.Clearnet, which is likely to remain a horizontal clearing house.

Another important evolution in the market has been the success of Amsterdam-based exchange The Order Machine (TOM). Founded in 2009, TOM has made significant inroads into the market share of option classes also listed on NYSE Euronext. In December 2012, Nasdaq took a 25% stake in TOM, with the option to increase it to 50.1%.

On the clearing side, TOM clears through EMCF (European Multilateral Clearing Facility), which is also able to serve other MTFs including BATS Chi-X, Burgundy, Nasdaq OMX Nordics and Turquoise.

There is also the wider issue to consider of EU regulation. Historically, the US had the advantage of a single currency and a single regulator. Until recently the EU had neither.

The European Commission has been extremely busy since the credit crisis promoting better risk management, putting in place EMIR (The European Market Infrastructure Regulation), which will compel suitable OTC trades to be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. Industry observers will also recall that the dominant listed derivatives position that a merged Deutsche Börse-NYSE Euronext would have created was a major reason why the proposed merger was blocked by Brussels.

Perhaps the increased focus on transparency and competition may join together to create a new European move to utility (or 'horizontal') clearing for equity options. It doesn't take an enormous leap of faith to believe that it is possible. Most European investors (the Dutch and Italian markets excluded) have never been as keen as their North American counterparts on options.

Given the rapidly expanding markets in competitor products like CFDs, spread betting and foreign exchange, perhaps the time has come for a fresh approach from the European equity option markets, embracing both utility clearing and enhanced investor education.

To quote Benjamin Franklin, "Gentlemen, we must all hang together, or we shall most assuredly all hang separately". Either way, the evolution of the European equity option market is likely to remain very interesting.

The views expressed are the author's own and should not be construed as the views of OIC.

FOA events calendar

IDX 2013
Tuesday 25 & Wednesday 26 June ~ The Brewery

The FIA and FOA are pleased to present the sixth International Derivatives Expo.

Last year's event welcomed over 1,000 delegates, over 40 exhibits showcasing the latest in products, services and technology for the derivatives industry and 20+ sessions with high-profile speakers, information-packed workshops and valuable networking opportunities.

Opportunities are available for Partnerships, Sponsors & Exhibitors (www.idw.org.uk).

IDX Gala Dinner 2013
Wednesday 26 June ~ Artillery Gardens @The HAC

The IDX Gala Dinner will once again be held in aid of Futures for Kids. The Dinner also provides a valuable networking opportunity for those attending IDX and the wider international financial community. Sponsorship opportunities and table reservations available for both FOA & non-FOA members.

FOA's Annual Power Trading Dinner 2013
Thursday 10 October ~ Sheraton Park Lane Hotel

Now in its 11th year, this black-tie dinner provides a valuable networking opportunity for members of the power and energy trading community. A wide range of sponsorship opportunities are available.

Operations & Technology Dinner 2013
Thursday 28 November ~ The Pavilion at The Tower of London

FOA announces its inaugural Operations & Technology Dinner. The dinner will provide a key networking opportunity for the futures industry's clearing, operations and technologies communities. The evening will also provide a forum to raise funds for Futures for Kids. Sponsorship opportunities and table reservations available for both FOA & non-FOA members.

FFK Poker Night
Thursday 23 May 2013: The London Capital Club

Sponsorship, tables and places available. For more information, visit www.futuresforkids.org.uk or contact Bernadette Connolly

Walk to Work
Friday 13 September 2013

Join FFK supporters on a walk to the City of London. Choose from four distances – c. 10, 20, 35 and... new for 2013... a 50-mile yomp! Choose from five starting points – Tunbridge Wells, Brighton (tbc), Guildford, Tring and Billericay. No entry fees – just commit to raise a minimum of £100 as an individual or £300 as a team. Sponsorship opportunities also available.

THE NEXT INFONET
Innovation in listed derivatives – where will it come from? Product? Process? Place?

Wednesday 15 May 2013 ~ 6.00 pm to 9.30 pm ~ Grocers Hall, Princes Street EC2R 8AD

Who can attend? This event is open to executives at FOA member firms and to specially invited guests of the FOA and InfoNet Sponsors

For more information on all events, please contact Bernadette Connolly on connollyb@foa.co.uk or +44 20 7090 1334

FOA news

REGULATORY ACTIVITIES

Regulatory reporting

The FOA is working with member firms to develop an industry approach to the implementation of reporting requirements under EMIR, with a specific focus on exchange traded derivatives. EMIR and its Technical Standards have been written primarily around OTC derivatives markets.

However, requirements to report to trade repositories capture both OTC and ETD derivatives, bringing unique challenges to the ETD world. To address this, the FOA believes it is essential that there is a degree of clarity around the technical standards for implementation in order for firms to adopt an industry standardised approach.

A Regulatory Reporting Working Group and sub-groups addressing core issues have been set up to help establish a common reporting approach. Representatives include firms, CCPs, vendors and trade repositories. For more information on FOA's Regulatory Reporting Working Group, contact Kathleen Traynor (traynork@foa.co.uk)

FOA NEWS RELEASES

PTF agrees implementation plans for calendar changeover for UK power

The FOA's Power Trading Forum (PTF) has been working on a project to shift UK physical forwards power trading over to the Gregorian Calendar from the EFA Calendar in a bid to remove what many felt was a barrier to the development of the UK power market. For more information, visit the FOA website and the Power Trading Forum page.

Industry call for IOSCO role in regulatory recognition

The FOA led the drafting of a letter to the *Financial Times* on behalf of a number of trade associations and exchanges on 19 March, calling for IOSCO and its board to assume the international responsibility for regulatory recognition for regulating cross-border business between countries with common regulatory approaches.

OPERATIONS

EMIR Client Documentation Projects

The FOA is involved in two initiatives to develop documentation that supports the clearing of both OTC and ETD client business post EMIR.

ISDA/FOA OTC Client Clearing Addendum: This document has been drafted over the past 9 months by a working group of major banks and buy-side firms – its aim is to offer the market a documentation solution that can apply to cleared transactions at any CCP, regardless of the underlying legal structures and thus avoids the need for clients to sign multiple prescribed documentation issued by individual CCPs.

FOA EMIR ETD Addendum: This document is currently under development by a dedicated FOA working group and Clifford Chance. This Addendum will allow firms to continue to use standard FOA terms of business post EMIR.

In the medium term, the FOA intends to provide its library members with a single terms of business document, which can be used in support of client clearing business across a wide range of derivatives.

For more information on the EMIR Client Documentation projects, please contact Hugo Jenkins or Mitja Siraj at FOA.

FOA introduces new netting opinion library

The FOA has launched its new legal opinions library – Netting Analyser – which will help subscribing firms to satisfy certain prudential regulatory requirements and reduce the increasing cost of regulatory capital.

The new library, developed in co-operation with Clifford Chance LLP, aims to provide access to a wider range of legal opinions than is currently available in the market. It comprises three sections: netting opinions; collateral opinions; and CCP opinions. For more information on the netter opinions library contact Mitja Siraj at sirajm@foa.co.uk or call +44 (0)20 7929 0081.

NEW FOA MEMBERS

The FOA is pleased to welcome the following recent new members:

- Investec Wealth & Investment
- Macfarlanes
- G H Financials
- Shearman & Sterling (London)