An Update on Worldwide Derivatives and Related Regulatory Initiatives

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Overview

- High frequency trading
- Reporting requirements under EMIR and Dodd-Frank
- Derivatives in the Middle East
- Australian end-user trade reporting
- Centralised clearing and derivatives regulation in Asia
- Dodd-Frank and EMIR extra-territoriality
- Margin proposals for non-cleared swaps
High Frequency Trading
Introduction

- Rise of technology and algorithms
- Flash Crash on 6 May 2010
  - Dow Jones Industrial Average fell by 1,000 points and recovered within a few minutes
- Disruptions on NYSE on 1 August 2012 by Knight Capital
  - Losses by Knight Capital of approx. USD 440 million
Regulation of HFT

- Final text adopted by European Parliament: 22/05/2014
- ESMA publishes discussion and consultation papers for MiFID II/MIFIR: 22/05/2014
- HFT-Act came into force: 26/11/2012
- Draft HFT-Act was introduced: 20/10/2011
- Transitional period for authorisation requirement for HFT-firms domiciled in Germany expired: 14/11/2013
- Transitional period for authorisation requirement for HFT-firms domiciled outside Germany expired: 14/02/2014
- Transposion of MiFID II into national laws: 12/06/2016
- MiFID II comes into force: 13/06/2014
- MiFID II to be transposed into national laws: 12/06/2016
- Transition period for authorisation requirement for HFT-firms domiciled in Germany expired: 14/11/2013
- Proposal adopted by Commission: 20/10/2011
- EU
- Today
**Definition of AT and HFT**

- **Trading for own account in financial instruments**

- **Algorithmic Trading**
  - where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission with limited or no human intervention
  - does not include any system that is only used:
    - for the purpose of routing orders to one or more trading venues
    - for the processing of orders involving no determination of any trading parameters
    - for the confirmation of orders
    - the post-trade processing of executed transactions

- **High-Frequency Trading**
  - infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access
  - system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders
  - high message intraday rates which constitute orders, quotes or cancellations
Infrastructure to Minimise Latencies

Latencies for EUREX:
- 0.2-0.35 ms for co-location
- 3.3 ms for Amsterdam
- 4.6 ms for Paris
- 4.6 ms for London
- 40 ms for New York
- 48 ms for Chicago

Source: www.eurexchange.com
Direct Electronic Access

- Direct Trading Participant
- Indirect Trading Participant
- Broker Dealer
- Direct Market Access
- Sponsored Access
- Matching Engine
- Trading Venue

High-Speed = 10 gigabit per second
High Message Intraday rates

- ESMA Consultation Paper 2014/549
  - **Option 1:** (approach taken by Germany)
    - trading frequency of two messages per second over the entire trading day on a rolling 12-month period
  - **Option 2:**
    - median daily lifetime of orders (having been modified or cancelled) of a member/participant is shorter than median daily lifetime of orders (having been modified or cancelled) in a given trading venue
# Overview of Implications for Trading

## Trading Venue

<table>
<thead>
<tr>
<th>Art. 48, 49 MiFID II</th>
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<tbody>
<tr>
<td>Systems Resilience and Capacity</td>
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<tr>
<td>Systems and Controls to reject orders:</td>
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<tr>
<td>• exceeding pre-determined volume or price thresholds; or</td>
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<td>• being clearly erroneous</td>
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### Circuit Breakers
- Order-to-Transaction Ratios
- Rules on DEA
- Minimum Tick-Sizes
- Algo-Flagging Rules
- Rules on Co-Location
- Fee Structures

## Firms providing DEA

<table>
<thead>
<tr>
<th>Art. 17 para. 5 MiFID II</th>
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<td>Effective systems and controls which ensure:</td>
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<tr>
<td>• a proper assessment and review of the suitability of clients using the service</td>
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<tr>
<td>• that clients using the service are prevented from exceeding appropriate pre-set trading and credit thresholds,</td>
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<tr>
<td>• that trading by clients using the service is properly monitored</td>
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<tr>
<td>• that appropriate risk controls prevent trading that may create risks to the investment firm itself or that could create or contribute to a disorderly market or could be contrary to Regulation (EU) No 596/2014 or the rules of the trading venue.</td>
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### Responsible for ensuring that clients using that service comply with the requirements of this Directive and the rules of the trading venue
- Monitor the transactions in order to identify infringements of those rules, disorderly trading conditions or conduct that may involve market abuse and that is to be reported to the competent authority
- Binding written agreement between the investment firm and the client regarding the essential rights and obligations arising from the provision of the service and that under the agreement the investment firm retains responsibility under this Directive
- Notify the competent authorities of its home Member State and of the trading venue at which the investment firm provides direct electronic access
- Provide, on a regular or ad-hoc basis, a description of the systems and controls
- Records to be kept in relation to the matters referred to in this paragraph and shall ensure that those records be sufficient to enable its competent authority to monitor compliance with the requirements of this Directive

## (In-)Direct Trading Participant

<table>
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<tr>
<th>Art. 17 para. 1, 2 MiFID II</th>
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<tr>
<td>Effective systems and risk controls suitable to the business it operates to ensure that its trading systems are:</td>
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<tr>
<td>• resilient and have sufficient capacity</td>
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<tr>
<td>• are subject to appropriate trading thresholds and limits</td>
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<tr>
<td>• prevent the sending of erroneous orders or the systems otherwise functioning in a way that may create or contribute to a disorderly market</td>
</tr>
<tr>
<td>• cannot be used for any purpose that is contrary to Regulation (EU) No 596/2014</td>
</tr>
<tr>
<td>• cannot be used for any purpose contrary to the rules of the trading venue to which it is connected</td>
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</tbody>
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### Notification of competent authority and trading venue
- Record keeping requirements
  - **In addition for HFT:**
    - Authorisation required
    - Store in an approved form accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders and quotations on trading venues and shall make them available to the competent authority upon request
Derivatives Reporting
Derivatives Reporting

U.S. Dodd Frank Act

- Trades executed on a SEF or cleared through DCO reported by the SEF/DCO
- One party to the trade is designated the reporting party:
  - Swap Dealer (regardless of whether it is a U.S. person or not)
  - Major Swap Participant
  - End User
- Parties that share the same registration status must agree on the reporting party; however, a U.S. party is the reporting party when trading with a non-U.S. party

EMIR

- All exchange traded and OTC derivative contracts
- All contracts entered into on or after August 16, 2012
- Timing T+1
- Both parties have obligation to report
- Original parties retain responsibility for compliance
  - Can delegate
    - Counterparty
    - Third-party
- Third Country Entities not in scope (see ESMA Guidance)
Derivatives in the Middle East
Doing Derivatives in the Middle East

- Recognised need for increased risk management across the region has led to the development of conventional and Islamic derivatives market across the GCC
- Development hindered by lack of legislation/regulation/ISDA netting opinions
- Unsophisticated market. Most common types of derivative products are:
  - Margin Trading
  - Cross-currency/Commodity/Interest Rate (Profit Rate) Swaps
  - Equity swaps
  - Total return swaps particularly in Saudi Arabia
Regulatory and Capacity Issues

- Federal law restrictions due to Shariah law implications
- Licensing requirements: Derivatives trading is a “commercial banking activity”; counterparties must be licensed by the relevant regulatory body unless all conduct with regard to derivative transactions is conducted outside relevant jurisdiction
- KSA: derivatives and commodities trading must be effected via an “authorised person”
- Conducting KYC: Verify that counterparties have power and authority to enter into derivative transactions:
  - Memo & articles of association/establishing decree
  - Commercial registration certificate
  - Banking/trade licence: renewable annually
  - Board resolutions: be wary of restrictions on limits of derivatives trading
  - Share register: check shareholdings for evidence of government owned counterparties
  - Corporate information may not be publicly available
Permissibility of Derivatives

- Civil Code prohibitions embodying Shariah principles:
  - Transactions for gambling purposes are void (Article 1021 of UAE Civil Code) - little case law defining “gambling” in the context of financial transactions
  - Dealings where a contract has no subject matter or deals with goods the identity of which is uncertain at the time the contract is made are not permitted (Articles 199-206 of Civil Code)

- Conflicting decisions by UAE courts
  - Dubai Court of Cassation relied on international banking practices to hold that currency futures trading does not violate the Commercial Transactions Code for impermissible risk or uncertainty; emphasis on counterparty being a professional licensed investor
  - Three Abu Dhabi court decisions in which foreign currency derivatives were invalidated for speculation
  - No other types of derivatives have been tested
  - No formal doctrine of precedent
Permissibility of Derivatives (cont’d)

- **In Practice**
  - If a derivative transaction is purely speculative or “excessively uncertain” there is considerable risk that UAE courts (especially Abu Dhabi) will adopt conservative approach
  - Limited guidance from Civil Code and case law means it is difficult to predict with certainty how the UAE courts will interpret a derivative transaction and its enforceability in UAE

- **Our recommendation**
  - Documentation should state clearly sophisticated nature of both counterparties and shared commercial rationale to hedge against pre-existing risk (e.g. in the Additional Representations section)
Netting and Close-out Netting/Automatic Early Termination

- No legalisation addressing close-out netting
- No ISDA netting opinions
- Pre-insolvency netting arrangements likely to be viewed as analogous to set-off by UAE courts
- Post-insolvency netting only permitted where right and obligation are “connected” i.e. if the right and obligation amount from a single cause or if they are comprised by a current account (Article 688 of Commercial Code)
- Sovereign immunity/enforcement issues
- Our recommendation
  - Connexity representations
  - Solvency representations
  - Waiver of immunity
Two Sided Trade Reporting in Australia
End-User (Two Sided) Trade Reporting in Australia

- Both counterparties to an OTC derivative have trade reporting obligations in Australia (some exceptions)
- Phased implementation - fund managers are generally "Phase 3"
- Phase 3 was to commence October this year
- Problems with this:
  - No licensed trade repository to report to
  - Most will delegate reporting but the industry isn't ready
  - The industry has had too much other reform to contend with
End-User (Two Sided) Trade Reporting in Australia (cont’d)

- Relief granted by ASIC on 30 June 2014:
  - Extends the date for compliance
  - Fund managers with >$5 billion total notional outstanding – earliest TR start date now April 2015
  - Fund managers with <$5 billion total notional outstanding – earliest TR start date now second half of 2015
  - May be determined at a fund level
- Some in the industry still hoping to have the requirement removed but this is unlikely
Asia
Centralised Clearing & Derivatives Regulations Update
China

- Effective 2 January 2014, Shanghai Clearing House launched a CCP clearing service for RMB interest rate swaps
Singapore

- Not a member of the G-20 but has consistently confirmed its intention to implement the group’s commitments.

- On 31 October 2013, the following provisions of the Securities and Futures Act (the “SFA”) came into force:
  - Part VIA which mandates reporting of over-the-counter (“OTC”) derivatives to licensed trade repositories or licensed foreign trade repositories (collectively, the “TRs”); and
  - Part VIB which mandates centralized clearing of OTC derivatives on central counterparties

- No proposal for mandatory trading of OTC derivatives at this stage, and likely to exempt foreign exchange forwards and swaps from this clearing obligation.
India

- Interest rate swaps (IRS) : optional CCP-based clearing will be operational by 2014
- FX forwards and swaps : existing optional guaranteed centralized clearing facility with mandatory CCP-based clearing for all interbank trades by end of 2014.
- FX options : mandatory CCP based clearing proposed to be made operational by end of 2014 for FX options.
- Decision on centralised clearing of IRS and credit default swaps trades expected by 2015 depending on market requirements.
**Japan**

- Mandatory clearing for JPY interest rate swaps

**Korea**

- Voluntary clearing of won interest rate swaps until 30 June 2014 with mandatory clearing thereafter
Hong Kong

- The Securities and Futures (Amendment) Bill 2013 (introduced into Hong Kong’s Legislative Council on 10 July 2013) provides for the regulation of participants in the Hong Kong OTC derivatives market.

- 2 new types of regulated activity under the Securities and Futures Ordinance:
  - Type 11 regulated activity (dealing in OTC derivative products or advising on OTC derivative products)
  - Type 12 regulated activity (providing clearing agency services for OTC derivative transactions)

- In addition, scope of Type 9 regulated activity (asset management) expanded to cover the management of a portfolio of OTC derivative products and Type 7 regulated activity (providing automated trading services) will be expanded to cover the provision of automated trading services for OTC derivative products.

- Introduction of mandatory OTC reporting, trading and clearing obligations.
Hong Kong (cont)

- OTC Clearing Hong Kong Limited (“OTC Clear”) launched its OTC derivatives clearing services in November 2013.
- OTC Clear currently provides clearing of inter-dealer trades on interest rate swaps and non-deliverable currency forwards on a voluntary basis.
- OTC Clear aims to introduce mandatory clearing services in the second half of 2014 after obtaining approval from the SFC.
Malaysia

- centralized clearing not contemplated. The scale of the Malaysian market is insufficient to make this viable

Taiwan

- centralized clearing not contemplated. The OTC products traded in the country are relatively simple and tightly regulated.
Dodd-Frank and EMIR Extra-Territoriality
Cross-Border Issues

U.S. Dodd Frank Act
- Sections 722 and 772
- Apply to non-U.S. transactions with “direct and significant connection with activities in, or effect on, commerce of the United States”

EMIR
- Article 4(2) (Clearing) and Article 11(12) (RMTs)
- Third Country Entities
- Contract has a “direct, substantial and foreseeable effect” within the EU
  - Guaranteed by an FC; or
  - Executed via the EU branches of the two TCEs
- Anti-evasion provisions
CFTC Cross-Border Guidance

- Commodity Exchange Act § 2(i)
  - Title VII of Dodd-Frank “shall not apply to activities outside the United States unless those activities have a direct and significant connection with activity in, or effect on, commerce of the United States or contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010.”

- CFTC approach clarified in July 12, 2013 Guidance Statement
  - Swap Dealer (or MSP) category
  - Counterparty category
  - Category of requirement
    - Entity Level (1st and 2nd)
    - Transactional Level (1st and 2nd)

- Legal challenge to CFTC Cross-Border Guidance Statement
U.S. Person Definition: Selected Issues

- 8 prongs to U.S. Person Definition, including:
- A “legal entity” (e.g., corporation, partnership, LLC, trust,…fund…or any similar form of enterprise) that (A) is organized or incorporated under US law or (B) has its principal place of business in the United States.
  - Principal place of business – “nerve center” – where high-level officers direct, control and coordinate the entity’s activities
  - For collective investment vehicles - location of senior personnel responsible for formation/promotion of vehicle implementation of investment strategy, depending on facts and circumstances
  - “The Commission generally believes that [a non-U.S.] person would not come within the “U.S. person” interpretation solely because it retains an asset management firm located in the United States…” (see FR 45312)
U.S. Person Definition: Selected Issues (cont’d)

- Any commodity pool, pooled account, investment fund, or other collective investment vehicle not described in the “legal entity” prong that is “majority-owned” by one or more U.S. persons, unless it is publicly offered only to non-U.S. persons and not offered to U.S. persons
  - Majority ownership test
    - Direct beneficial owners and “looking-through” the beneficial ownership of entities controlled by or under common control with the fund
    - May rely on representations of an unrelated investor entity unless formed for the purpose of avoiding “looking through”
    - Reasonable due diligence
  - “Publicly offered”
    - Not defined but the publicly offered vehicle “could be a UCITs” (see FN 224)
    - Exception is intended to address comments that ownership verification would be particularly difficult for publicly offered vehicles
Margin Proposals for Non-Cleared Swaps
BCBS/IOSCO Principles (September 2013)

- BCBS/IOSCO Principles for margin requirements for non-centrally cleared derivatives
  - Initial and variation margin
  - Physically settled FX forwards and swaps are exempt from initial margin, but not variation margin
  - Permits one-time rehypothecation
  - Initial margin threshold of EUR 50m
EMIR Article 11 and Draft RTS (April 2014)

- European Supervisory Authorities (ESAs) consultation paper and draft RTS
  - Draft RTS includes:
    - Margin models
      - Two step approach for mark-to-market and mark-to-model
      - 99% confidence interval
      - 10 day risk horizon
      - Netting within classes not across
      - Validation, back-testing and audit)
    - Collateral eligibility (wider than BCBS/IOSCO and subject to diversification requirements)
  - Operational processes and risk management
    - Outright prohibition on rehypothecation
    - Comment period ends on 14 July
    - In force from 1 December 2015 and phased in until 1 December 2019
      - Thresholds based on aggregate month end average notional value
      - EUR 3 trillion to EUR 8 billion
Questions