

Derivatives

OTC Derivatives Clearing: How Does It Work and What Will Change?

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New over-the-counter (OTC) derivatives regulations have been proposed in both the U.S. and the E.U., which once finalized will affect how market participants trade, provide margin with respect to and settle OTC derivatives.^[1] The new regulations will have an impact on the liquidity, transparency and pricing for these products and a key component of both regimes will be the central clearing of certain standardized swaps. If a market participant wishes to engage in a swap that is of a type that the applicable regulator has determined must be cleared, the swap must be submitted to a clearinghouse for clearing unless an exception applies. While certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act passed by the U.S. Congress last year will become effective on July 16, 2011, most key provisions are expected to be finalized by the end of 2011.^[2] In Europe, the new derivatives regulations proposed by the European Commission are still pending.^[3] OTC derivatives clearing will therefore soon become a reality for most market participants in the U.S. – including many hedge funds – as well as foreign market players trading these products with U.S. counterparties.

This article describes the clearing process, how hedge funds and other market participants will trade and access clearing and what will change from the current bilateral trading model. We also address margin requirements and how trades and margin are protected in the event of default by a dealer (clearing member). Finally, we provide a general overview of the documentation governing contractual relationships among market participants.

What Will Be Cleared and Who Will Be Required to Clear?

Only liquid, standardized products capable of being priced daily will be centrally cleared. Regulators will determine which products are required to be cleared. The various factors recently proposed by the Commodity Futures Trading Commission (“CFTC”) to make such a determination include the degree of standardization of the products, the existence of applicable outstanding notional exposures, trading liquidity and adequate pricing data, as well as certain systemic risk mitigation and legal certainty criteria. Products for which clearing solutions are already currently offered today, such as interest rate swaps and index credit default swaps, are expected to be the first products required to be centrally cleared under Dodd-Frank.

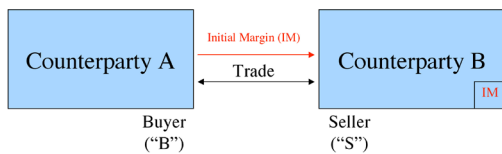
Once a product is required to be cleared, all market participants trading that product will be required to clear it unless an exception applies. Dodd-Frank only provides for a limited exception to mandatory clearing, commonly known as the “end-user” exception. This exception effectively circumscribes the application of the mandatory clearing requirements for certain categories of commercial end-users of swaps that were not intended to be the primary targets of the new regulations and that are hedging commercial risk.^[4]

From Bilateral Trading to Clearing

In a “bilateral” trading model, a derivatives trade is typically entered into exclusively between two contracting

counterparties (as shown in Figure 1, where, for example, Counterparty A, as Buyer (“B”), may purchase a swap product from Counterparty B, as Seller (“S”).

Figure 1

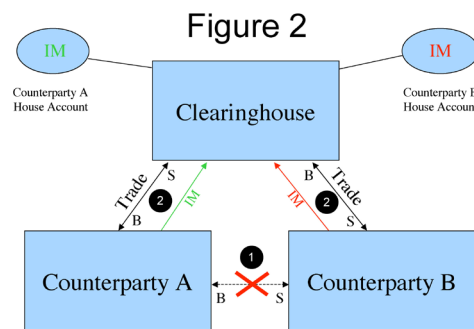


In most instances, the relationship between the parties is governed by an International Swaps and Derivatives Association, Inc. (ISDA) master agreement addressing issues such as termination, valuation and close-out netting. Counterparties also negotiate collateral arrangements and, during the life of a trade, each party will post variation margin to the other party to account for the market value of the trade. Initial margin (which is an additional amount of collateral that is posted on each trade at its initiation to account for potential future exposures deriving from the expected volatility of a particular transaction and credit concerns) is also posted but, generally, only by the customer and not by the dealer counterparty. In a bilateral context, each party takes counterparty credit risk exposure to the other party.

In contrast, central clearing involves the interposition of a regulated clearinghouse between the two original trading parties. The trade between the two parties is replaced (through a process called novation) with a pair of trades on identical economic terms but with the clearinghouse. Each trading party faces the clearinghouse instead of its original counterparty and the clearinghouse becomes the counterparty to each of the original trading parties.

Take, for example, an original buyer (Counterparty A) and

an original seller (Counterparty B) who execute a swap to be cleared by a clearinghouse. Once the swap is cleared, the original trading parties maintain their original position with respect to the underlying trade (i.e., each trading party maintains its position as either a seller or a buyer), but they each face the clearinghouse directly and no longer have exposure to each other. In turn, the clearinghouse becomes the buyer to the original seller and the seller to the original buyer and, therefore, is economically neutral. Figure 2 illustrates this process:



If one of the original trading parties defaults, the clearinghouse is contractually obligated to pay all amounts owed to the non-defaulting party in respect of the underlying trades.

Clearing also alters margin posting requirements. In a bilateral trading market, parties freely negotiate which party will be required to post collateral, under which circumstances, and how much collateral will be required. In contrast, clearinghouses require each trading party to post both initial margin and variation margin. This is a major departure from the bilateral trading context where swap dealers typically do not post initial margin. Also, margin calls may become more frequent as clearinghouses determine the mark-to-market

value of underlying trades on an intra-day basis and may call for additional collateral more than once per day. Also, the amount of initial margin required by the clearinghouse will not take into account the creditworthiness of the parties and will mainly be based on the perceived riskiness of a particular trade (taking into account certain liquidity and volatility criteria among other things).

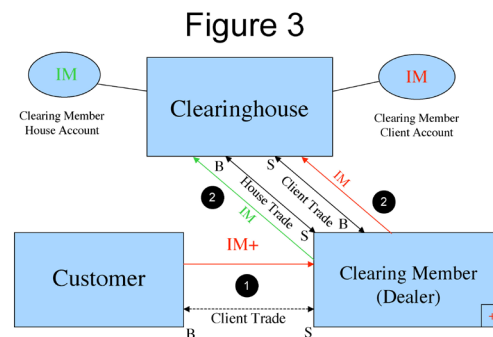
How Do Market Participants Access Clearing?

Market participants may access clearing by becoming a clearing member of one or more clearinghouses, which would effectively enable the participant to self-clear its derivatives trades and act as a conduit into the clearinghouse for its customers. However, clearinghouses have established strict membership requirements designed to assure that applicants have adequate financial resources, industry expertise, operational capabilities and risk management experience to become a clearing member. Membership requirements typically include substantial minimum capital requirements and contributions to a guarantee fund (used to cover shortfalls in the event of a default by a clearing member), as well as the posting of performance bonds guaranteeing the clearing member's settlement and margin payment obligations. As a result, even though clearinghouses are independent and neutral, only certain significant market participants are expected to qualify and seek to become clearing members. All other market participants will have to access clearing through a clearing member.

Trades Entered into with a Customer's Clearing Member

A customer may enter into a trade with a dealer that will also act as the customer's clearing member and clear the trade on the customer's behalf with a clearinghouse. Once the customer and the clearing member have traded, the clearing member submits the trade for clearing to the

clearinghouse. The original trade is replaced with two trades between the clearing member and the clearinghouse: the client trade with respect to which the clearing member acts as agent on behalf of the customer and the proprietary house trade with respect to which the clearing member acts as principal (and thereby takes the other side of the trade). Once the trade has been cleared, both the customer and the clearing member maintain their original positions with respect to the underlying trade, but they now face the clearinghouse. Figure 3 illustrates this process (adopting the same hypothetical as in Figure 1 where a customer buys a derivatives product from its clearing member):



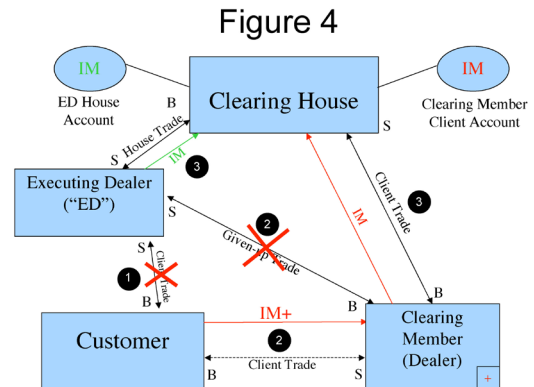
Both parties will post to the clearinghouse the amount of initial margin it requests and calculates. The customer's initial margin will be posted to the clearing member and passed to the clearinghouse where it will be segregated from the initial margin posted by the clearing member. In the bilateral structure, dealers often have the right to freely use the margin posted by their counterparties for operational needs or investment purposes. Under the clearing framework, the dealers will lose access to this source of liquid assets. This, in turn, will have pricing implications for customers who will ultimately bear the costs of clearing. Variation margin will also be posted by both counterparties but it will flow through

the clearinghouse and be held by the original counterparties to the trade.

Furthermore, because the clearing member will guarantee performance by the customer to the clearinghouse with respect to the underlying cleared trade, the clearing member will likely request additional margin from its customer.^[5] In the event the customer defaults, the clearing member will likely close out the customer's positions with the clearinghouse and, if the clearing member incurs losses in that process, it will use the additional amount of margin posted by the customer to cover such losses.^[6]

Trades Entered into with a Customer's Executing Broker

A customer may want to enter into a transaction with a dealer that is not also acting as the customer's designated clearing member. The dealer in such a case is typically referred to as an executing broker. In this scenario, once the customer and the executing broker have traded, pursuant to a give-up agreement, the executing broker and the customer's clearing member, acting as an intermediary on behalf of the customer, enter into the trade (subject to the trade being accepted for clearing by the clearinghouse). This process is similar to a prime brokerage relationship where prime brokers settle securities and other transactions that customers enter into with executing brokers with the difference being that, in the context of a swap, the trade must be cleared. The executing broker^[7] and the clearing member then submit the trade for clearing to the clearinghouse. Both the executing broker and the customer (through its clearing member) will then face the clearinghouse and post initial margin that will be held in separate accounts at the clearinghouse as described above. Figure 4 illustrates this process:



A Note on Applicable Clearing Models

Existing platforms for OTC derivatives clearing operate on either an agency or principal-to-principal basis whereby the clearing member acts as either agent or principal vis-à-vis the customer. In the U.S., the agency model embedded in the legal framework applying to futures has been embraced by Dodd-Frank through the requirement that only CFTC registered Futures Commission Merchants may accept margin or collateral for cleared swaps. Under the agency model, a clearing member that clears a trade for a customer acts as an intermediary (agent) for an undisclosed principal (the customer) vis-à-vis the clearinghouse and guarantees the customer's performance to the clearinghouse. Collateral posted by a customer must be treated as belonging to the customer and segregated. UK-based clearinghouses have generally operated under a principal-to-principal clearing model where a principal-to-principal trade is recorded simultaneously between the clearinghouse and the clearing member and between the clearing member and its customer. Under that model, the customer typically obtains a security interest in the initial margin posted by its clearing member to the clearinghouse with respect to the underlying trade. For the customer, there does not seem to be any apparent difference between the two models; however, in the U.S., the

agency relationship is embedded in the Commodity Exchange Act and the CFTC regulations and is viewed as essential to facilitate customer protection in the event of a bankruptcy of a clearing member (see “Portability and Segregation” below).

Trade Execution Platforms, Transparency and Reporting

The new regulations will also alter the manner in which market participants enter into swaps subject to the clearing requirement and will have an impact on pre-trade and post-trade transparency.

While swaps are currently privately traded by both counterparties, swaps subject to the clearing requirement under Dodd-Frank will also be required to be executed on an exchange or a so-called swap execution facility (“SEF”) to the extent that the swap is made available for trading on such platforms.^[8] A SEF is intended to be a transparent trading system or platform where, as presently proposed by the CFTC, all market participants having access to the trading system or platform can enter multiple bids and offers, observe bids and offers entered by other market participants, and choose to transact on such bids and offers. If a SEF offers an open multiple-to-multiple facility, it may also establish a request for quote system where a market participant can transmit a request for a quote to buy or sell a specific instrument to at least five market participants. The receivers of the request respond on the SEF, which in turn communicates to the requester these responses as well as responses from other market participants who might have seen the request for quote and acted on it.

Proposed reporting rules under Dodd-Frank would also require SEFs to send swap transaction and pricing data to a

registered swap data repository or third-party service provider who will publicly disseminate the data. Certain block trades (i.e., large swap transactions exceeding a minimum threshold notional amount) would be excluded from certain trading and reporting requirements.

Open and transparent trading platforms such as SEFs are intended to provide pre-trade transparency to market participants. Pre-trade market opacity has been criticized by some as creating and concentrating market and bargaining power in the hands of a few swap dealers, enabling them to generate and earn substantial profits in trading these products. Trading platforms would also promote post-trade transparency as all market participants would have access to important pricing information as they consider whether to lower perceived risks or make investments using those products. In addition, during the life of a trade, clearinghouses will be required to disclose pricing information regarding cleared derivatives products.

The implementation of SEFs and clearing, in general, is designed to improve efficiency in the market in the event of a clearing member’s default.

Portability and Segregation: How Are Customer Trades Protected in the Event of a Default by Their Clearing Member?

As mentioned above, many derivatives counterparties will not be able to self-clear and will have to access clearinghouses through a clearing member. Customers could thus potentially be exposed to a default by their clearing member. Two interrelated mechanisms, portability of trades and segregation of collateral, are intended to mitigate the impact of a default by a customer’s clearing member.

Portability of trades refers to the ability of a customer to move (port) trades from one clearing member to another clearing member that has agreed to accept those positions. Prior to a default, clearing members are typically required by law to promptly transfer a customer's trades to another clearing member as designated by the customer. Once a clearing member has become insolvent, applicable insolvency laws typically seek to preserve these rights. There is, however, a limited time period during which the clearinghouse may effectuate porting. Furthermore, the ability of a customer to port its trades to another clearing member will depend on how easily margin posted by such customer is identifiable (i.e., how it has been segregated) at the clearinghouse.^[9]

These issues highlight the importance of having relationships in place with more than one clearing member.

Under the U.S. futures framework, clearing member and customer margin are required to be segregated, but all collateral posted by customers is commingled in an omnibus account. This system hampers the portability process because not only does it make it more difficult to trace the collateral posted by each individual customer, but it also creates so-called fellow customer risk. Fellow customer risk arises if a customer defaults and there is a deficit in such customer's margin account balance at the clearinghouse and the clearing member in turn defaults because it does not have sufficient resources to cover such deficit. In such a situation, other (fellow) customers may face the risk that the clearinghouse uses the collateral posted by such fellow customers to cover for a deficiency.

Portability may be facilitated and fellow customer risk mitigated or eliminated by appropriately segregating margin posted by customers. A complete segregation model where

customer margin would be held in bankruptcy remote accounts would provide a high degree of protection. However, it would be more costly and probably also affect customer incentives to monitor the creditworthiness of their clearing members. The model recently proposed by the CFTC contemplates a complete legal segregation under which clearinghouses would be permitted to commingle customer collateral in one account but would only have recourse to the collateral posted by a defaulting customer if both such customer and its clearing member simultaneously default.

Documentation Overview

Futures Agreements

The contractual relationship between a swap customer and a clearing member will typically be governed by a futures agreement. A futures agreement is a type of master agreement incorporating a close-out netting mechanism and dealer-friendly provisions relating to payment and margin obligations, customer default, termination, cross-liens, liability standards, account transfers and reporting. Futures agreements typically incorporate clearinghouse rules, including those providing for the economic terms of the cleared products, together with an agreement from customers to be bound by such rules. Futures agreements are generally designed to house both traditional exchange traded futures and options and cleared OTC derivatives products, though issues specific to cleared OTC products will be addressed in a separate addendum subject to negotiation by the parties (see below).

Cleared Derivatives Transactions Addendum

An addendum covering cleared swaps will supplement the futures agreement between the parties. The Futures

Industry Association (“FIA”) has been working with market participants on a form of Cleared Derivatives Transaction Addendum that most dealers are expected to adopt as the basis for their customer documentation. The addendum typically contains provisions relating to optional transfer, early termination, termination for cause and payment withholding and provides for a calculation methodology in the event of early termination. Customers should carefully review these provisions to avoid any unwanted disruption in their trading strategy, to reduce the likelihood of an early termination event, and to address liquidity and counterparty credit risks among other things.

Give-Up Agreements

Customers will also need to enter into give-up agreements to access trading counterparties (executing brokers) other than their clearing member(s). The FIA together with ISDA recently published a form of give-up agreement (Cleared Derivatives Execution Agreement) intended to be used by market participants in connection with cleared swaps. The agreement sets forth the procedure to be followed by the customer and the executing broker to affirm or reject a trade. The agreement also provides for the steps that the parties may take if the trade is not accepted for clearing by the clearing member or the clearinghouse and the consequences associated with such events. Customers should carefully review give-up agreements to understand the risks associated with a failure to clear and negotiate applicable protective provisions and remedies to mitigate those risks.

A Word on Timing

Even though Dodd-Frank requires regulators in the U.S. to finalize most rulemaking by July 16, 2011, it became apparent

that this deadline would not be met as, by mid-June, the CFTC and the Securities and Exchange Commission (“SEC”) had issued very few final rules, none of which is a key final rule with respect to derivatives. The CFTC and the SEC have provided market participants some relief by deferring most requirements regulating derivatives products under Dodd-Frank until the earlier of December 31, 2011, or the date on which the relevant rules are finalized, further subject to the phased implementation dates included in the final rules.^[10] Also, some have suggested that clearing requirements first be imposed on dealer-to-dealer swaps (and only with respect to certain types of clearable swaps) and then later applied to dealer-to-customer relationships and other clearable swaps. It therefore appears that a certain degree of phasing-in of the new regulations will be necessary. In the meantime, market participants should educate themselves on the new regulations and start developing policies, procedures and infrastructure and negotiating legal documentation needed to comply with and adapt to the new regulatory framework.

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^[1] Note that this article will address principally the new derivatives regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) though many aspects of the U.S. regulations will also be relevant in the context of the proposed European Union regulations.

^[2] Regulators in the U.S. have recently postponed the

implementation of certain of Dodd-Frank’s self-executing provisions.

^[3] European Market Infrastructure Regulation (“EMIR”) and the Markets in Financial Instruments Directive (“MiFID”).

^[4] See Fabien Carruzzo, “The End-User Clearing Exception,” 45 *Swiss Derivatives Review* 20 (Spring 2011).

^[5] Dodd-Frank requires the clearing member to segregate such additional margin from the clearing member’s own assets.

^[6] This additional margin is indicated by the “+” sign in Figure 3.

^[7] This assumes that the executing broker is also a clearing member; otherwise one of the executing broker’s affiliates that is a clearing member will be substituted.

^[8] In Europe, electronic trading requirements are addressed in MiFID.

^[9] This is one of the reasons why clearing members will not be entitled to post net initial margin across their customers’ aggregate positions.

^[10] See “CFTC Staff Concepts and Questions Regarding Phased Implementation of Effective Dates for Final Dodd-Frank Rules.”