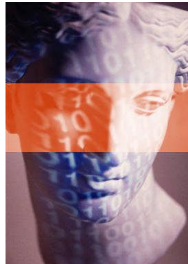
White Paper

Discussion Series on Financial Regulations

IQ3 Solutions Group www.iq3group.com info@iq3group.com



Fighting Dodd-Frank: Is smart politics, smart business?

By Michael "Mack" Frankfurter, Partner *November 7, 2012*

Notwithstanding the outcome of the election, it may have been smart politics to fight Dodd-Frank, but is it smart business going forward? Throughout the primary and general election season, Republicans have repeatedly invoked the law's 848-page girth—and its rules on, among other things, trading derivatives and swaps—as a symbol of government overreach that is killing jobs.[1]

As noted by Michael Greenberger, professor at the University of Maryland's Francis King Carey School of Law, tactics used to try and stop Dodd-Frank include attempts at blocking its passage, starving regulators financially so the law cannot be enforced, and most recently, challenging the final rules with a flood of lawsuits in federal courts claiming that regulators have used improper cost-benefit analyses.[2]

The evidence of the fight to reduce Dodd-Frank's impact on derivatives trading is scattered throughout the regulations promulgated by the CFTC.

There seems to be two major themes underlying Wall Street's resistance. The first is the cost Dodd-Frank will impose on certain institutions' existing business models, exposing these firms to either more competition, or rendering certain lucrative ways of doing business no longer viable. The second is the cost of implementing and/or upgrading technology to properly support the deluge of new requirements, some which contemplate the building of infrastructure that currently does not exist.

The evidence of the fight to reduce Dodd-Frank's impact on derivatives trading is scattered throughout the regulations promulgated by the CFTC. The final rules contain a summary of comments by industry participants and discussion of the CFTC's views in response. Take for example the discussion surrounding customer clearing documentation and trilateral agreements…

Six commentators[3] went into detail why trilateral agreements are bad for the markets, noting that such agreements discourage competition and efficient pricing, compromise anonymity, reduce liquidity, increase the time between execution and clearing, introduce conflicts of interest, and prevent the success of swap execution facilities (SEFs).

Opposing this view were many of the major banks[4] who contend that without the trilateral agreements some market participants may have reduced access to markets. The banks suggest that "instead of prohibiting trilateral agreements, the CFTC could require that the allocation of credit limits across executing counterparties be specified

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by the customer, rather than the futures commission merchant (FCM), who would confirm the customer's allocation to the identified executing counterparties."

Contrary to such protests the CFTC asserts that the rules do not prohibit trilateral agreements; rather, they prohibit certain provisions contained in trilateral or bilateral agreements. Further, the CFTC emphasizes that nothing in these rules would restrain a swap dealer (SD) or major swap participant (MSP) from establishing bilateral limits with each of its counterparties, much less impair a SD's or MSP's ability to conduct due diligence on each of its counterparties.

In fact, rather than discouraging competition, law prohibits an SD or MSP from adopting any process that imposes any material anti-competitive burden on trading or clearing. In addition, derivatives clearing organization (DCO) rules provide for the non-discriminatory clearing of swaps.

This would seem conceptually amenable, but it is argued that pre- and post-trade uncertainty caused by a delay between the time of trade execution and the time of trade acceptance into clearing, would undermine market integrity, and by implication impede liquidity, efficiency and market stability.

Accordingly, the CFTC revised language to clarify that, for swaps that will be submitted for clearing, an SD or MSP may continue to manage its risk by limiting its exposure to the counterparty with whom it is trading. This clarification is intended to both emphasize the need to conduct appropriate risk management, as well as address the concern that until straight through processing is achieved, SDs and MSPs will still need to manage risk to a counterparty before a trade is accepted or rejected for clearing.

And therein lies the crux of the matter. For prompt and efficient clearing to occur, the rules, procedures and operational systems of the trading platform and the clearinghouse must align. Vertically integrated trading and clearing systems currently process high volumes of transaction quickly and efficiently. But they also form a monopoly.

Under the distributed structure contemplated by Title VII, each SEF and designated contract market (DCM) is required to assure equal access to all DCOs that wish to clear trades executed through the facilities of the SEC or DCM.

The technological issue then is minimizing the time between trade execution and acceptance into clearing. This time lag potentially presents credit risk to the swap counterparties, clearing members, and the DCO because the value of a position may change significantly between the time of execution and the time of novation, thereby allowing financial exposure to accumulate in the absence of daily mark-to-market.

Thus, what is not often discussed in the political furor over Dodd-Frank is how this legislation is driving industry participants toward "prompt, efficient, and accurate processing of trades" while simultaneously encouraging competition. An initiative to improve and better integrate front to back office processing on such a large scale has not been seen by the industry since the "paper crunch" of the 1970s, and the passing of the Securities Act Amendments of 1975. In our opinion, it's about time.

Reference:

Federal Register /Vol. 77, No. 68/Monday, April 9, 2012/Rules and Regulations. 77 FR 21278 - Customer Clearing Documentation, Timing of Acceptance for Clearing, And Clearing Member Risk Management. Agency: Commodity Futures Trading Commission. Action: Final rule.

Footnotes:

[1] Edward Wyatt, Dodd-Frank Act a Favorite Target for Republicans Laying Blame, New York Times, September 20, 2011

[2] Michael Greenberger, Will Wall Street prevail? The Baltimore Sun, October 8, 2012.

[3] The Alternative Investment Management Association Ltd; Javelin Capital Markets, LLC; Societe Generale; Asset Management Group of the Securities Industry and Financial Markets Association (SIFMA); Spring Trading, Inc.; Vanguard.

[4] Bank of America; Merrill Lynch; BNP Paribas; Citi; Credit Suisse Securities (USA) LLC; Goldman Sachs; HSBC; J.P. Morgan; Deutsche Bank; Edison Electric Institute; ISDA; Morgan Stanley; Societe Generale; UBS Securities LLC.

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