Impact of Market Structural Reform

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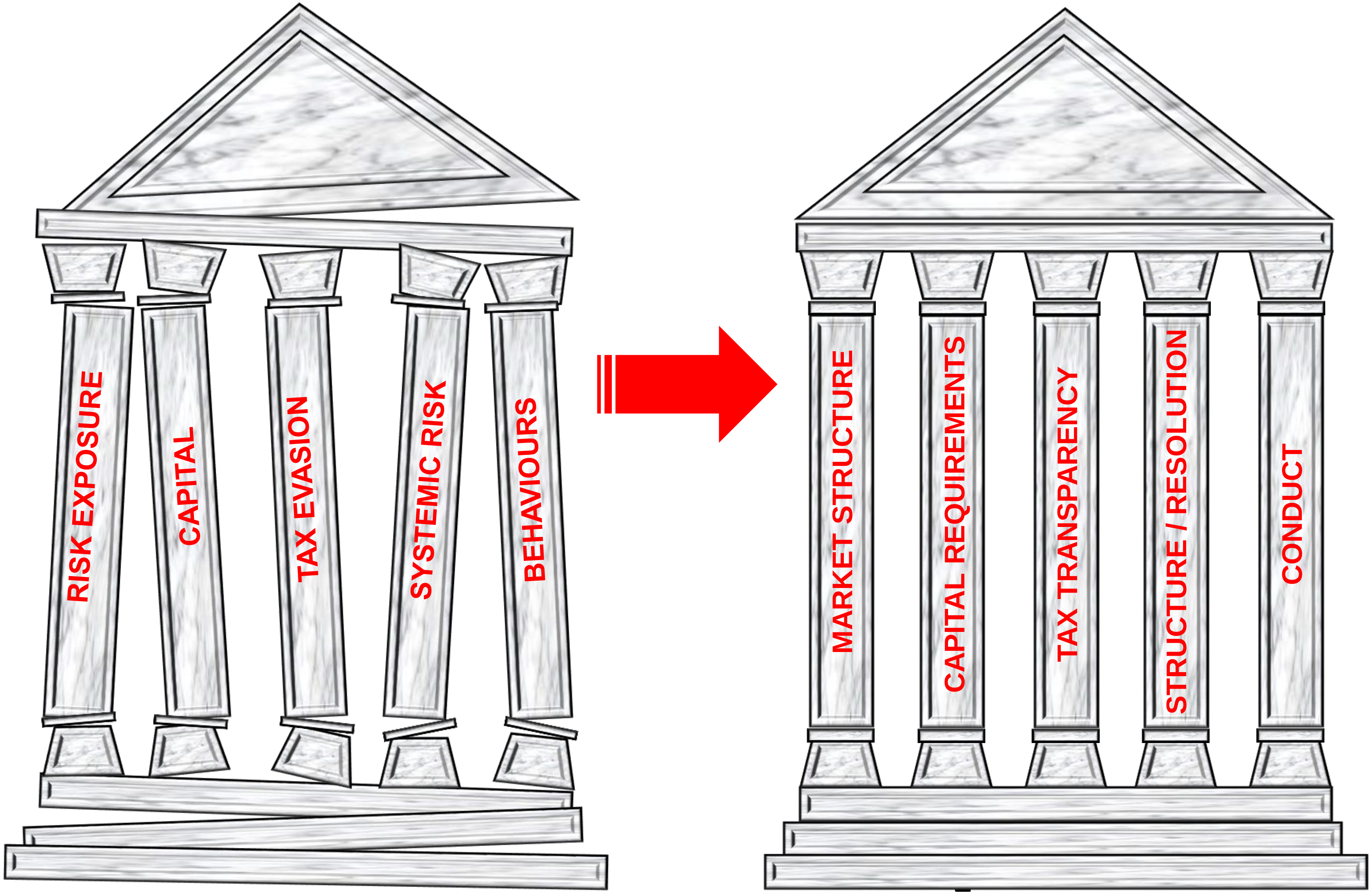
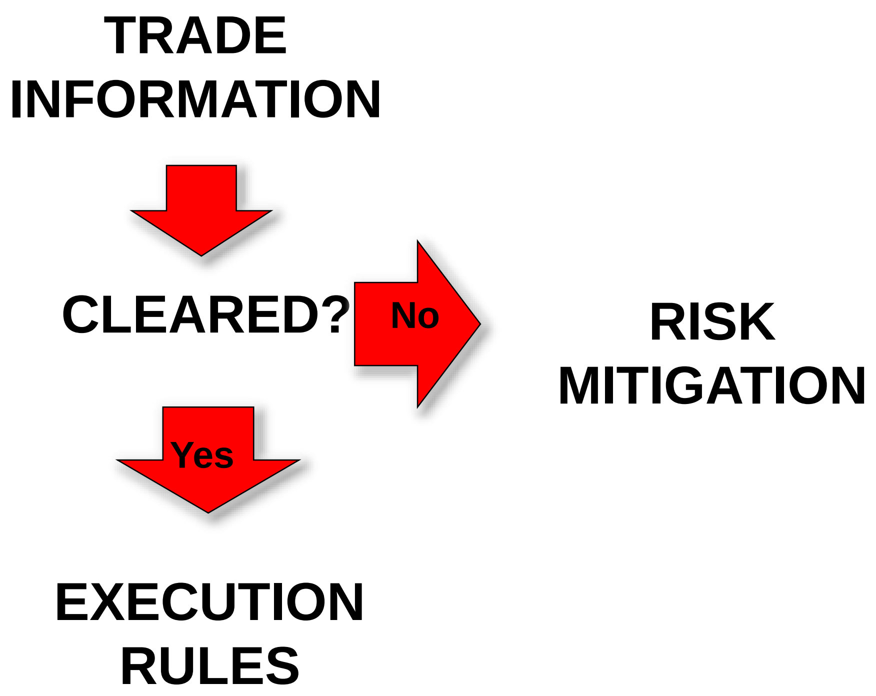
June 2014

HSBC

Lessons Learned from the 2008 Crisis



Implementation of Reform



4 - Dodd-Frank Act Title VII

Key requirements for the CFTC regime

A Registration

- Entities are required to register as Swap Dealers (SD) if dealing activity is above USD8bn notional of swaps involving US persons or certain non-US Persons benefitting from US guarantees in the last 12 months.

B Internal Business Conduct Rules

- Mandate a suite of standards that SDs must follow. These include trade confirmation timelines, portfolio reconciliation and portfolio compression requirements.
- IBC also introduced the requirement for SDs to have a Chief Compliance Officer, and defined his/her duties.

C External Business Conduct Rules

- Define how SD must manage client relationships and communicate with customers.
- This rule was the first that required wholesale agreement of new documentation across the industry.

D Trade Reporting

- Trades are required to be reported in real-time as they are executed. Open trades are updated on a daily basis.
- The reporting rules also involve the introduction of standardised data attributes across the industry including Legal Entity Identifier (LEI), Unique Swap Identifier (USI), Unique Product Identifier (UPI)

E Mandatory Clearing

- Mandatory clearing for certain classes of liquid swaps. The products that must be cleared are determined by the CFTC.
- Mandatory clearing has limited exemptions for end-users and inter-affiliate trades.

F Execution

- Mandatory execution of trades on a Swap Execution Facility (SEF) for certain liquid cleared trades. The products that must be executed on SEF are determined by the CFTC.
- Mandatory execution was introduced in 2014 and has led to a decline in market liquidity.

G Margining

- Un-cleared swaps are subject to margin requirements (expected Dec 2015)

H Capital Adequacy

- Requirement to hold appropriate collateral to manage uncollateralised risk (expected Dec 2015)

EMIR
Key regulatory requirements

A Reporting

Requirement to report all new and outstanding derivatives, OTC and ETD (Exchange Traded Derivatives), to a registered trade repository, including trades with TCEs*.

B Clearing

- Requirement to clear OTC derivatives that ESMA has determined subject to a mandatory clearing obligation through a central counterparty ("CCP") including trade with TCEs
- Heightened regulatory requirements for CCPs.

C Risk Mitigation for uncleared derivatives - including transacted with TCEs

Timely confirmation

- Establish "appropriate procedures and arrangements" to ensure the timely confirmation of all of the terms of uncleared OTC derivatives, within specified deadlines.
- Use electronic means (platforms or systems, not emails) where possible.

Mark-to-market valuation

- Mark-to-market on a daily basis the value of all outstanding derivatives. Mark-to-model can be used in certain circumstances (e.g. inactive markets).

Portfolio Reconciliation

- Agree in writing the arrangements under which portfolios will be reconciled.
- The frequency of the reconciliation depends on the counterparty's classification and the volume of outstanding derivatives.

Dispute Resolution

- Agree procedures to identify, record and monitor disputes and resolve them in a timely manner.
- FCs must report disputes of more than €15m outstanding for 15 business days.

Portfolio compression

- Entities with 500 or more uncleared OTC derivatives outstanding with a single counterparty must analyse (at least twice a year) the possibility of portfolio compression.

Initial and variation margin

- Requirement to have procedures for the exchange of collateral

Capital requirements

- Hold appropriate capital to manage uncollateralised risk

* TCE (Third Country Entity): an entity established outside of the EU that would be subject to the relevant EMIR obligation if established in the EU

Comparing two Market Structure reforms: EMIR and Dodd-Frank Act Title VII

Key similarities

Both Dodd-Frank Title VII and EMIR introduce the following requirements:

- Clearing
- Margin rules based on Basel/IOSCO rules
- Portfolio Compression
- Portfolio Reconciliation and dispute resolution
- Timely confirmations
- Trade Reporting (with some differences)

Key differences

- **Geography**

Dodd-Frank Title VII has a broader extra-territorial reach: all entities worldwide with trading activities involving US Persons. EMIR has no concept of "EU person"

- **Entities**

Dodd-Frank Title VII rules focus largely on registered swap dealers whereas EMIR applies to all derivatives users with some exemptions for non-financial institutions

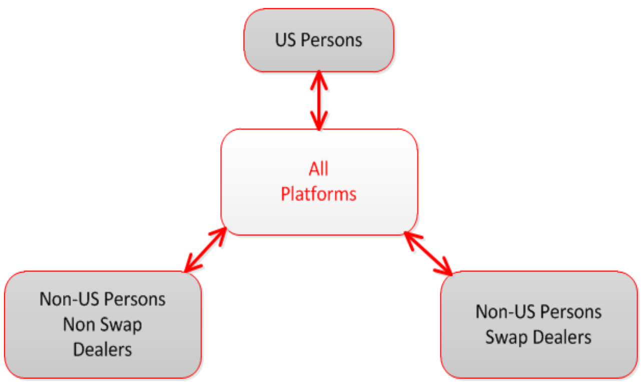
Implementation

- Dodd-Frank Title VII External Business Conduct rules cover **sales practices** whereas sales practices in the EU are already covered by MiFID.
- Dodd-Frank Title VII mandates **execution on exchange (SEF)** for liquid cleared derivatives whereas mandatory execution in the EU will be introduced through MiFIR.
- Dodd-Frank Title VII incudes a real-time reporting requirement on top of the end-of-day reporting.
- Dodd-Frank Title VII mandates **public dissemination of trade reports** whereas public reporting in the EU will be introduced through MiFIR.

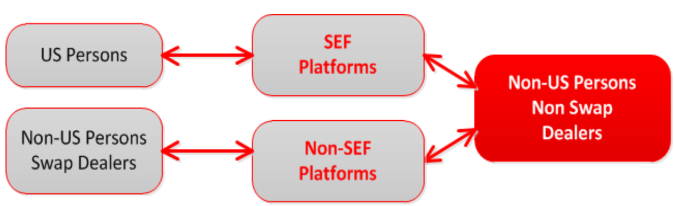
Industry impacts – Execution Rules
Risks of fragmentation

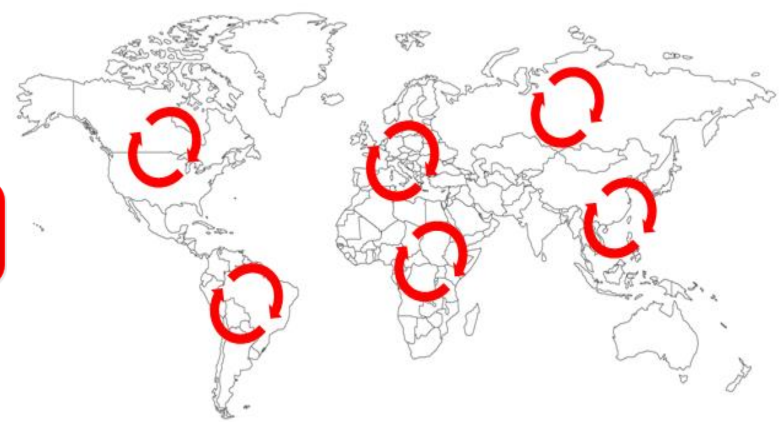
The Dodd-Frank Act introduced mandatory execution on a Swap Execution Facility (SEF) for certain liquid cleared trades in 2014, which has led to a decline in market liquidity.
The products that must be executed on SEF are determined by the CFTC.

Today



Tomorrow?





Clearing and Margin Requirements

- CFTC introduced mandatory clearing rules for certain categories of liquid swaps. EMIR expected to introduce mandatory clearing rules towards end of 2014
- Existing requirements do not cover FX products (although we expect NDFs to be mandated under CFTC rules soon)
- Margin requirements for uncleared derivatives expected to be defined towards end of 2015
- Increased liquidity costs
- Resulting in level of risk concentration in Clearing Houses

Industry Impacts & Challenges

- **Regional implementation differences makes it difficult for institutions to consolidate and manage risk efficiently**
- **Fragmentation of liquidity observed**
- **Pricing may have to consider market reaction to large trades with increased reporting transparency**
- **Clients will increasingly require Legal assistance with navigating through regulatory changes particularly when faced with extraterritorial impacts**

HSBC Finance Regulation Website

- HSBC Financial Regulation website developed to help stake-holders including clients develop broad understanding of regulatory reform

- http://www.hsbcnet.com/financial-regulation

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