newsBRIEFS

International Regulators Propose Capital Treatment of CCP Exposures

On June 28 the Basel Committee on Banking Supervision launched two consultations on the capital treatment of derivatives-related risk exposures. Comments on both consultations are due by Sept. 27.

One consultation sets out a proposal for calculating regulatory capital requirements for bank exposures to central counterparties, including contributions to default funds and "trade exposures." The proposal is designed to ensure that these exposures are "adequately capitalized while also preserving incentives for central clearing," the Basel Committee said. The proposal also is designed to address weaknesses in the interim standard published by the Basel Committee in July 2012.

The second consultation outlines a proposal to improve the methodology for assessing counterparty credit risk associated with derivatives. The proposed "non-internal model" method would replace existing methods.

IOSCO Publishes Principles for Financial Benchmarks

On July 17 the International Organization of Securities Commissions published its final report on principles for financial benchmarks. The principles are designed to enhance the integrity, the reliability and the oversight of benchmarks by establishing guidelines for benchmark administrators and other relevant bodies. The report also offers a subset of more detailed principles for benchmarks having specific risks arising from their reliance on submissions and/or their ownership structure. The report calls for benchmark administrators to publicly disclose their compliance with the principles within 12 months.

One of the key recommendations is that benchmarks should be "anchored" by observable transactions. This does not mean, the report says, that individual benchmark determinations must be constructed solely or even predominantly from transaction data. Expert judgment, information about bids and offers, and extrapolations from prior transactions can also play a role.

In related news, the Financial Stability Board announced on June 25 that it has formed a steering group of market regulators and central banks to coordinate reviews of interest rate benchmarks such as Libor and examine whether the governance and processes around these benchmarks meet international standards. The steering group will also convene a market participants group to review "options" for developing "robust reference rates that meet the needs of the private sector" as well as any transition issues. The steering group will be chaired by Martin Wheatley, chief executive of the U.K.'s Financial Conduct Authority, and Jeremy Stein, governor of the U.S. Federal Reserve Board.

U.S., U.K. Regulators Fine High-Speed Trader for Spoofing Commodity Futures

Using new enforcement powers granted by the Dodd-Frank Act, the CFTC announced on July 22 that it reached a settlement with Panther Energy Trading and its principal Michael Coscia on charges that the firm engaged in "spoofing" in numerous commodity futures markets.

Panther settled the CFTC charges without admitting or denying the allegations and agreed to pay a $1.4 million civil monetary penalty and turn over $1.4 million in trading profits. The New Jersey-based company also accepted a ban from trading on any CFTC-registered entity for a year.

"While forms of algorithmic trading are of course lawful, using a computer program that is written to spoof the market is illegal and will not be tolerated," said David Meister, the CFTC's enforcement director. "We will use the Dodd-Frank anti-disruptive practices provision against schemes like this one to protect market participants and promote market integrity, particularly in the growing world of electronic trading platforms."

In a parallel action, the U.K.'s Financial Conduct Authority fined Coscia $903,173 on charges of "deliberate manipulation" of commodities markets in its jurisdiction, namely ICE Futures Europe. The FCA alleged that between Sept. 6, 2011 through Oct. 18, 2011, Coscia used an algorithmic program to instigate an abusive trading strategy known as

FOA and FIA to Form Closer Partnership

The Futures and Options Association and the Futures Industry Association announced an agreement in principle on June 21 to form an affiliation of the two organizations under a new global structure called FIA Global.

This new structure will enable the associations to strengthen their influence on cross-border issues, increase the coordination and information flow between regions, and provide a powerful global voice to express the views of their members. FOA is based in London and FIA is based in Washington, D.C.

"This builds on a transatlantic partnership which has been growing in strength for more than a decade," said FOA Chief Executive Officer Anthony Belchambers, adding that it "will put both organizations in a better position to meet a new wave of global challenges and lead the way towards greater harmonization of international regulatory standards."

"Through this new affiliation we will be better able to coordinate our responses to global issues and provide industry support for global standards," said FIA President and Chief Executive Officer Walt Lukken. "This will be tremendously beneficial for our members and policymakers alike."

The agreement in principle has been approved by the FOA and FIA boards of directors and on July 24 FOA members voted to approve the constitutional changes necessary to implement the agreement. To reflect the affiliation with FIA and to develop a consistent brand worldwide, it is proposed that FOA will change its name to FIA Europe. Both organizations will continue to operate with their own leadership and staff, separate boards of directors, and distinct membership, with FIA Global serving as a mechanism for coordinating their activities.

"layering," placing thousands of false orders for Brent crude oil, gas oil and WTI crude oil futures on ICE Futures Europe. The FCA said Coscia's orders made up a significant proportion of the total demand and supply on the order book, at times accounting for more than 50% of the market depth within five ticks of the best bid and offer price at the time.

JSCC Revises OTC Clearing Rules ahead of Client Clearing Launch

Japan Securities Clearing Corporation has revised its rules for clearing interest rate swaps as it prepares to begin offering client clearing early next year. According to a July 1 notice, the clearinghouse is shortening the time period from execution to clearing, establishing new requirements for its clearing members, and introducing new account types and margin processes.

The clearinghouse also is introducing a "position transfer structure" to allow client positions to be transferred from one clearing member to another and "bulk compression processing" to reduce the number of outstanding contracts. JSCC said it plans to work with Trioptima, an ICAP subsidiary that provides compression services to several other clearinghouses, to provide this service.

The move to client clearing, expected in March, will cement JSCC's position as the leader in the Asia-Pacific region in terms of interest rate swaps clearing. JSCC began clearing dealer-to-dealer yen-denominated interest rate swaps in October 2012 and it currently has 21 clearing members eligible to clear interest rate swaps for themselves and certain affiliates. Most of the swaps cleared to date have been yen-denominated plain vanilla swaps based on Libor rates, but the service also covers Tibor swaps as well as basis swaps in both Libor and Tibor and Libor vs. Tibor swaps.

Australia Moves toward Clearing Mandate

In a change of policy, Australian financial regulators are recommending that the government consider a central clearing mandate for interest rate swaps denominated in U.S. dollars and three other major foreign currencies, rather than continuing to rely on voluntary adoption of central clearing.

In a report issued on July 17, the regulators noted that some participants in the Australian market are already subject to the mandatory clearing requirements of other jurisdictions. In addition, the largest Australian banks are already clearing a substantial proportion of their new trades via the client-clearing arrangements they have with participants in offshore clearinghouses.

The regulators recommended that the initial focus should be on dealers with "significant cross-border activity" in these four classes of interest rate swaps. With respect to interest rate swaps denominated in Australian dollars, the regulators said they will continue to monitor the voluntary implementation of clearing and will review the case for recommending a mandate in their next report, which is planned for early 2014.

China Poised for Bond Futures Re-Launch

By Nick Ronalds

China's State Council in July approved the re-introduction of government bond futures, paving the way for trading to resume after an 18-year hiatus. Government officials explained that the re-introduction will support the liberalization of interest rates and meet the risk management needs of bond holders. China's domestic bond market has grown rapidly in recent years and is now estimated to be the second largest in Asia after Japan and among the largest in the world.

Trading may begin as early as September, according to the China Securities Regulatory Commission. The bond futures contracts will be listed on the China Financial Futures Exchange in Shanghai, which has been running mock trading since February 2012. The contracts will be based on the five-year government bond and will have physical delivery at settlement, according to draft rules published by CFFEX on July 8.

The contracts will have a notional value of one million yuan, which is about $162,000 as of the mid-August exchange rate of Y6.16 to the dollar. That will make the contract fairly large relative to other government bond futures contracts around the world. The U.S. five-year Treasury note futures have a notional value of $100,000, for example, and the Euro Bobl futures have a notional value of €100,000 euros ($132,840). Tick size will be relatively small at one-fifth of a basis point or 20 yuan. Three contract months on the quarterly cycle will be listed at a time. Though it is called a five-year contract, the deliverable basket includes any bonds with between four and seven years to maturity remaining as of the first day of the delivery month.

One key factor in driving demand for the new contract will be bank participation. Banks are an important part of the domestic bond market and hold a large share of the outstanding supply, so they have a natural interest in using bond futures to hedge their holdings. The government has said it intends to allow banks to trade bond futures, but up to now banks have not been allowed to access the futures markets, so this would be a significant change in policy.

More than half of the deliverable supply of existing bond issues is owned by the Chinese banks, and the banks have to keep most of that supply locked away to meet prudential liquidity requirements. Only around 15% of their holdings are in accounts they can use for trading. Only 4% of Chinese sovereign bonds are held by securities firms, but they account for well over half the trading volume in the cash market. The upshot is that the float, or value of bonds freely tradable, is only Y200 billion (equivalent to about $32 billion) for any delivery month.

The expectation is that the government will grant approval to a small number of banks to participate during an initial phase, and then open it to other banks at a later date. During the bilateral U.S.-China talks in July, Chinese officials indicated that foreign banks, securities firms and institutional investors will be permitted to participate in the new market, but it is not clear how soon this will come about.—*Nick Ronalds is managing director at the Asia Securities Industry and Financial Markets Association.*

In separate but related news, the Australian government gave LCH.Clearnet permission to offer interest rate swap clearing directly to Australian banks. In effect, this will allow Australian banks to become members of LCH.Clearnet's Swapclear service, rather than having to rely on other banks to provide this service. LCH.Clearnet clears interest rate swaps denominated in Australian dollars as well as more than a dozen other currencies.

ASX is also moving forward with its plan to offer clearing to the same market participants. On July 1 the Australian exchange group began offering clearing for dealer-to-dealer transactions in certain types of interest rate swaps denominated in Australian dollars. Initially these will include fixed vs. floating, OIS and basis swaps. ASX stressed that it will be able to offer reduced margins for participants with offsetting positions in interest rate futures and options listed on ASX as well as "close to real-time novation" of positions during the Australian day. ASX also plans to begin offering clearing for client trades by the end of the year.

Cybercrime Threat on the Rise, Exchanges and Regulators Warn

Exchanges urgently need to develop stronger protections against computer attacks and other types of cybercrime, according to a report issued in July by the International Organization of Securities Commissions and the World Federation of Exchanges. The report, which was based on a survey of 46 exchanges, found that cyber threats are becoming increasingly sophisticated and "difficult to combat, detect and mitigate." More than half of the exchanges in the survey reported they had experienced encounters with cybercrime in the past year. The most common types of encounters were "denial of service" attacks and coded viruses.

The potential threat was underscored later that month, when U.S. prosecutors charged a group of Eastern European hackers with accessing data and stealing sensitive information from banks and other businesses dating back to 2005. One hacker in the group, a Russian national named Alexander Kalinin, was indicted on separate charges for breaching servers at the Nasdaq Stock Exchange between 2008 and 2010.

According to FBI officials, the 26 year-old Russian hacker was able to exploit a weakness in a password-reminder section of the Nasdaq website and successfully enter the exchange's network. Over time he was able to penetrate the network and install software on Nasdaq servers that allowed him to execute commands to delete, alter or steal the exchange's data, including historical market data. The officials said, however, that the infected servers did not include the exchange's trading platform.

The IOSCO/WFE report noted that cybercrime attacks on exchanges up to now have been mostly "disruptive in nature" and not necessarily responsible for theft or financial loss. The report described different types of cyber-attack techniques, details of each technique, and the security weakness that the attacks exploit. The report identified "prevention, detection and recovery mechanisms" across four categories: reactive defense, proactive defense, detection, and disaster recovery. The report also noted a need for "information sharing, dedicated monitoring, security awareness campaign and education" to help combat the cybercrime threat.

In related news, the Securities Industry and Financial Markets Association conducted an exercise on July 18 to prepare industry members for a system-wide cyber attack. The exercise, called Quantum Dawn 2, involved 500 individuals from 50 participating entities, including exchanges, regulators and financial companies. Participants were faced with a series of simulated attacks aimed at disrupting trading in the U.S. equity markets. No real systems were affected, but the exercise gave participants an opportunity to practice their response strategies, share information with other firms and regulators, and improve procedures. Sifma said it plans to analyze the simulation results and work on recommendations for security improvement.

Australia's ASX Strengthens Clearing Resources

ASX announced on June 11 that it intends to raise A$553 million in equity as a part of a broader effort to strengthen the financial resources that back its clearing services. In an investor presentation, the Australian exchange group said A$200 million will be contributed to its futures clearinghouse in order to "strengthen the position of ASX Clear (Futures) to compete on a global basis" and enable it to meet "emerging international capital standards for central clearing counterparties."

ASX explained that the increased capital will meet the "cover two" provision in the European Market Infrastructure Regulation, which requires European clearinghouses to withstand the default of the two clearing members with the largest risk exposures. ASX said it plans to seek ESMA recognition, which is necessary to continue providing clearing services to EU clearing members. Once the capital raise and various other measures have been implemented, the total size of the futures default fund will rise from A$370 million to A$650 million.

U.S. Accounting Standards Board Recognizes Fed Funds Rate as Hedging Benchmark

The Financial Accounting Standards Board issued a statement in July that it will now recognize the Fed Funds Effective Swap Rate, also referred to as the Overnight Index Swap Rate, as a benchmark for hedge accounting purposes. FASB, which sets accounting standards in the U.S., said the decision reflects the "increased prevalence of OIS in the marketplace" since the credit crisis of 2008 and the greater demand for hedging the Fed funds rate.

Prior to this decision, FASB only recognized interest rates linked to U.S. Treasury securities and the Libor swap rate as benchmarks in its hedge accounting standards. The change in policy effectively eliminates a significant disincentive for the use of swaps referencing the Fed funds rate to manage interest rate risk. Effective

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July 17, corporate treasurers can account for newly entered swaps as hedges in their financial statements.

FASB said that including the Fed Funds Effective Swap rate as an acceptable U.S. benchmark will provide risk managers with "a more comprehensive spectrum" of interest rate benchmarks. FASB also noted that OIS is becoming more widely used in the U.S. financial market as an underlying basis for determining the interest rates of collateralized derivatives and other financial instruments.

ESMA and CFTC Agree on Mutual Acceptance of Legal Entity Identifiers

The CFTC issued an amended order on June 10 which expands the list of permitted issuers of "Legal Entity Identifiers" to include various non-U.S. organizations, provided that other regulators are willing to accept LEIs used in the U.S.

Previously DTCC-SWIFT was the only utility designated by the CFTC as a provider of LEIs. The CFTC noted that WM Datenservice, a European utility, has begun issuing "General Entity Identifiers" that are anticipated to become LEIs in the global system, and commented that other utilities may follow.

The order will allow an entity that does business internationally to use one global LEI rather than one LEI for each jurisdiction. The CFTC will allow swap counterparties and registered entities to use GEIs in the reports required by U.S. reporting rules as soon as ESMA accepts the equivalent U.S. identifier for data reporting required by European rules.

International Regulators Propose Guidance on Clearinghouse Recovery Plans

The Committee on Payment and Settlement Systems and the International Organization of Securities Commissions on Aug. 12 published a consultation with guidance on establishing recovery plans and other safeguards for financial market infrastructures, such as clearinghouses, payment systems, securities settlement systems and trade repositories.

"The disorderly failure of a [financial market infrastructure] could lead to severe systemic disruption if it caused markets to cease to operate effectively," the international regulators said.

The consultation also provides guidance to relevant authorities in carrying out their responsibilities associated with the development and implementation of recovery plans and tools.

Comments must be submitted by Oct. 11.

International Regulators Assess Compliance with Market Infrastructure Standards

The Committee on Payment and Settlement Systems and the International Organization of Securities Commissions issued its first progress report on implementing the standards established in the Principles for Financial Market Infrastructures published in April 2012.

The progress report, which was issued on Aug. 11, showed that most jurisdictions have begun the process of implementation. Only a few have completed the process for all types of financial market infrastructures, but many are making good progress and expect to be well advanced by the end of the year.

The next round of so-called "Level 1" assessments will be conducted later this year for publication in early 2014.