The changing nature and landscape of the European hedge fund industry

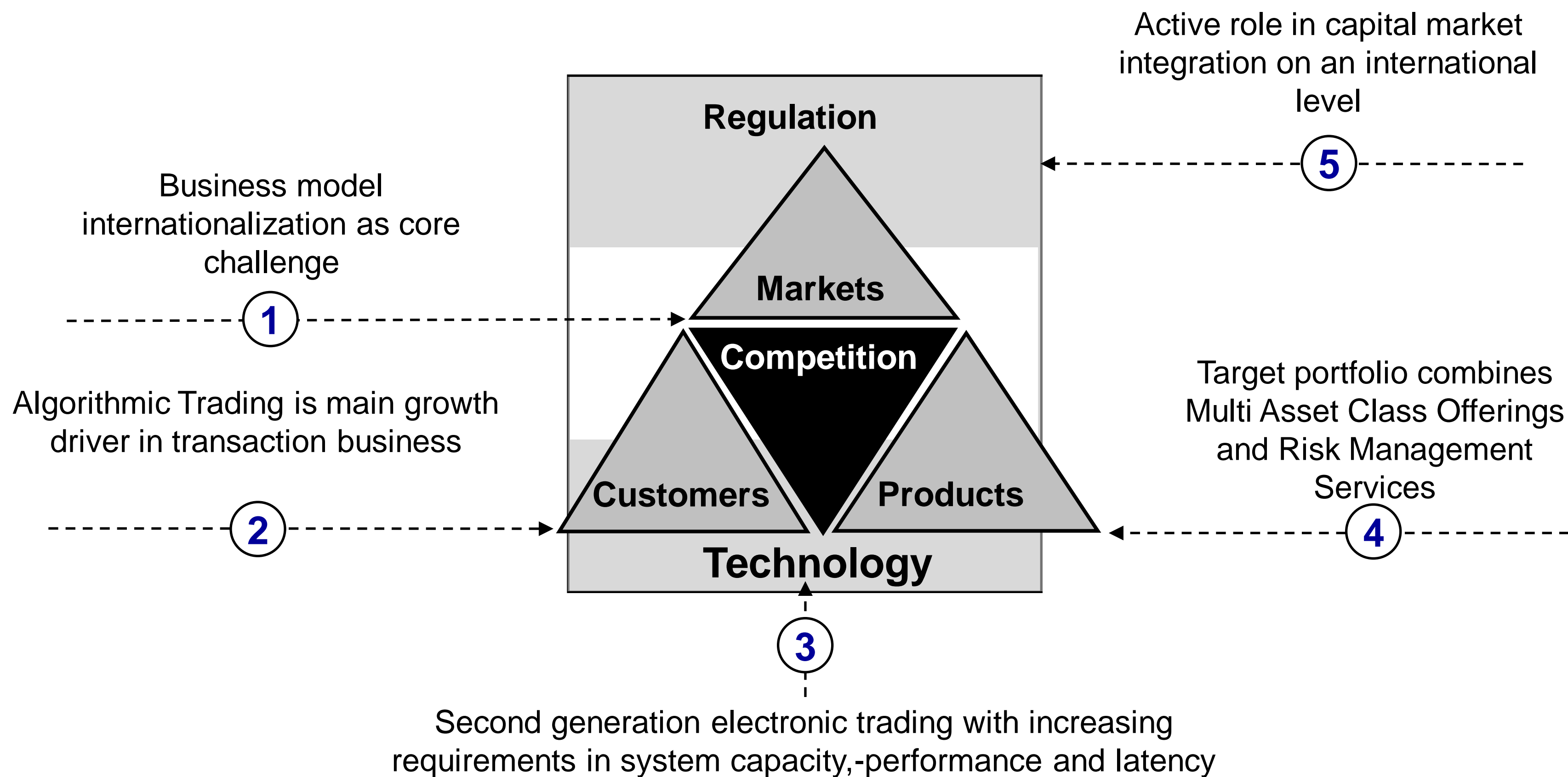
Known Unknowns and Unintended Consequences

December 5, 2012

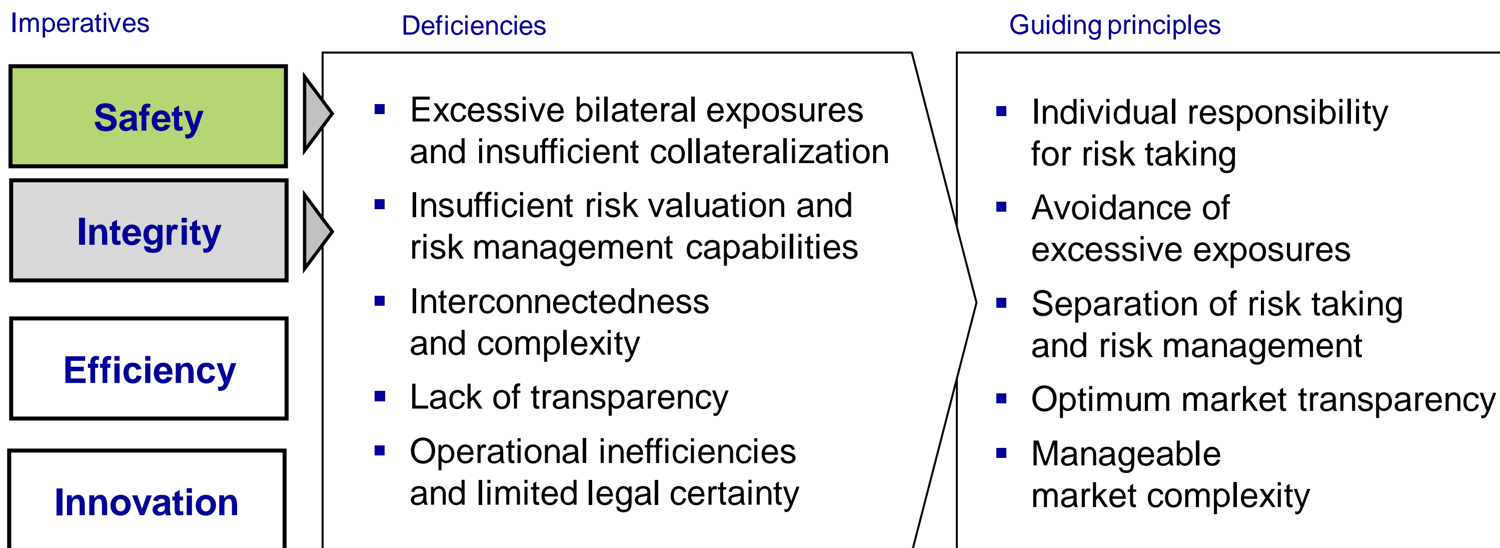
Agenda

- The Exchange Landscape
- Regulatory Structure
- CCP Structure
- US / EU Regulation
- Trading
- Post Trading
- Likely Effects
- Conclusion

Exchange landscape in change – Five elements are main drivers in the competition of the market operators



Rethinking Regulatory Structure – What Do Our Financial Markets Need?



Objective - Reduce systemic risk to increase financial market stability

Against the backdrop of the financial crisis, parts of the derivatives market have proven resilient, parts have shown deficiencies

Resilience of the derivatives market

- Continued liquidity for exchange-traded and standardized OTC derivatives throughout the crisis
- Effective counterparty risk management and mitigation by CCPs without market disruptions and spillover effects (e.g., in default case of Lehman Brothers)
- Full transparency on CCP-cleared and other registered trades for assessing and managing risk positions

Proven value proposition of on-exchange segment

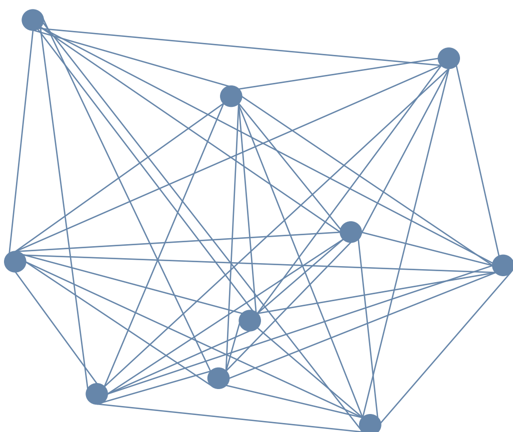
Market deficiencies

- Excessive buildup of bilateral exposure and insufficient collateralization
- Insufficient risk valuation and management capabilities for derivatives
- High interconnectedness of derivatives market participants and undesirable market complexity
- Lack of transparency in OTC derivatives market
- Operational inefficiencies and limited legal certainty

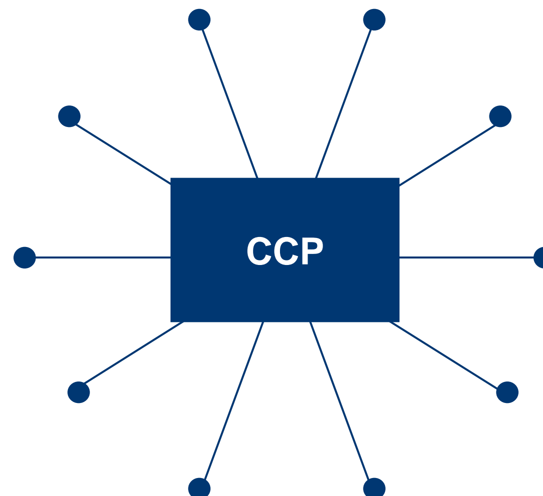
Details on next pages

Complexity reduction through CCP clearing

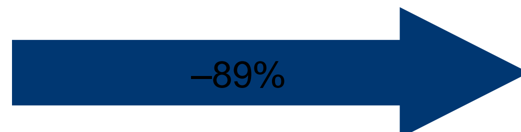
Bilateral market organization



Multilateral market organization via CCP



10 market participants
90 counterparty relations

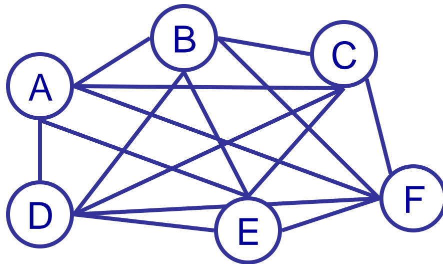


10 market participants
10 counterparty relations

Central clearing services improve safety and integrity of market infrastructure

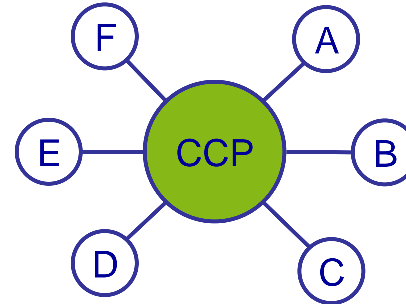
Current OTC market structure – 1:n relationships

Bilateral trading & clearing



Proposed OTC market structure – 1:1 relationships

Bilateral trading & multilateral clearing



Benefits of multilateral clearing with OTC Central Counterparty

1 Reduced systemic risk

- CCP takes over counterparty risk through trade novation
- CCP enforces strict risk control and adequate collateralisation of open positions
- Multilateral netting reduces gross risk exposure

2 Increased transparency

- Transparency in position risks by central instance
- Neutral position valuation by independent institution
- Early warning function by daily mark-to-market (profit and loss balance)

3 Efficiency gains

- Full automation and straight-through-processing reduces manual errors
- Efficient use and management of collateral
- Increased capital efficiency by reduced balance sheet exposure

US/European Regulation – edited highlights

US	
Dodd-Frank Act (DFA)	The Dodd-Frank Act (DFA) imposes business conduct standards on swap dealers (SDs) and major swap participants (MSPs). The law will be implemented through final rules adopted by the U.S. Commodity Futures Trading Commission (CFTC) amending regulations under the Commodity Exchange Act (CEA). Introduced on October 12, 2012 but will only apply to SDs registered under the CEA and SDs need not register before December 31, 2012. MSPs need not register before February 28, 2013.
European	
EMIR	The European Market Infrastructure Regulation (EMIR) which sets out to increase stability within OTC derivative markets. The Regulation introduces reporting obligations; clearing obligations; measures to reduce counterparty credit and operational risk and introduce common rules for central counterparties (CCPs) and for trade repositories (TRs). The supporting technical standards are issued by ESMA.
MiFID II/MiFIR	The update to the Financial Instruments Directive (MiFID) the purpose of MiFID is to promote cross-EU provision of investment services while protecting the investor and supporting market integrity and work is currently undertaken on MiFID II/MiFIR, which in combination with EMIR will set out the EU equivalent to DFA. The proposed directive and regulation (MiFID II/MiFIR) are unlikely to be implemented before 2015.
MAD II/MAR	The Market Abuse Directive (MAD2/MAR) was implemented in the UK on 1 July this year. The MAD creates an EU-wide regime covering insider dealing and market manipulation.
SSR	The Short-Selling Regulation (SSR), which provides a common framework for regulating short selling across Europe, and applies from 1 November 2012.
AIFMD	The Alternative Investment Fund Managers Directive (AIFMD) provides a common EU approach to bringing hedge funds, private equity and other types of funds within the scope of regulatory supervision, and to bringing transparency to the way these funds operate.
CRD IV	The Capital Requirements Directive (CRD IV) is intended to incorporate into EU law the revised Basel Capital Framework (Basel III) on bank capital adequacy standards. Note the Basel II Accord is still being implemented, Basel I was implemented by EU legislation in the Capital Adequacy Directive.
SOLVENCY 2	The Insurance Solvency 2 Directive (Solvency 2), which is intended to develop a new, risk-based capital requirements framework for insurance firms throughout the EU and to promote convergence of supervisory practice among European regulators.

Trading

Risk Appetite

1. Legislation signals a huge leap in bank capital (especially Tier 1) that needs to be held against all risk positions, this is especially true where these are not centrally cleared.
   This will lead to a significant increase in costs or reduction in risk appetite.

2. Where risk positions are held collateral (initial margin) is now required by both sides to a trade (rather than one), the cost of access and managing that collateral is significant.
   This will lead to a significant increase in costs or reduction in risk appetite.

3. Short-selling bans makes it more difficult for derivatives trades using cash hedges to manage exposures. There will be an increased cost in guaranteeing stock availability.
   This will lead to a significant increase in costs or reduction in risk appetite.

4. Limits on High Frequency Trading will decrease risk appetite of all HFT participants including liquidity providers and there will be additional cost in monitoring activity.
   This will lead to a significant increase in costs or reduction in risk appetite.

Post Trade

Infrastructure Costs

1. Legislation pushes all risk exposure into central clearing. Operational risk management will lead to IT infrastructure changes at banks, funds and custodians to facilitate STP
   This will lead to a significant increase in required infrastructure investment .

2. Enhanced position, risk and collateral management, collateral transformation and account management and cash segregation is now required by both sides to a trade.
   This will lead to a significant increase in required infrastructure investment.

3. Regulatory focus to force OTC trading onto electronic platforms and the push to introduce competition amongst platform providers and subsequent connectivity.
   This will lead to a significant increase in required infrastructure investment.

4. Increased transparency reporting and reporting requirements not just from major swaps players but pension and hedge fund investors an large corporate treasuries
   This will lead to a significant increase in in required infrastructure investment.

Likely Effect

Risk Reduction

1. As risk is reduced so are revenues and returns on capital leading to an overall decline in income and volume of business favouring larger incumbents.
2. Declining revenues and declining volumes will lead to an increased cost per transaction favouring those with economies of scale.
3. Those with higher marginal costs and lower diversity will be marginalized as specialists or will simply exit the business.

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Infrastructure Expenditure

1. As infrastructure costs increase and risk mitigation measures due to increased connectivity are required only those able to allocate significant resources can compete.
2. The basic requirements to undertake regulated business are significantly higher increasing the barrier to entry of new participants.
3. Increased transparency and public reporting reduces the incentives of smaller participants and value-added players in favour of bulk processors.

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KEY THEMES

CONCLUSIONS

1. Bank consolidation with the majority on international financial transactions undertaken by a handful of mega-banks.

2. Buy-Side concentration with a small number of big fund managers for pension and investment management.

3. Consolidation of central-counterparties - a huge increase in directional risk towards a reduced number of counterparties.

have they answered the question

“too big to fail?”

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