



TABB
GROUP

Centrally Cleared CFDs: The Buy-Side Perspective

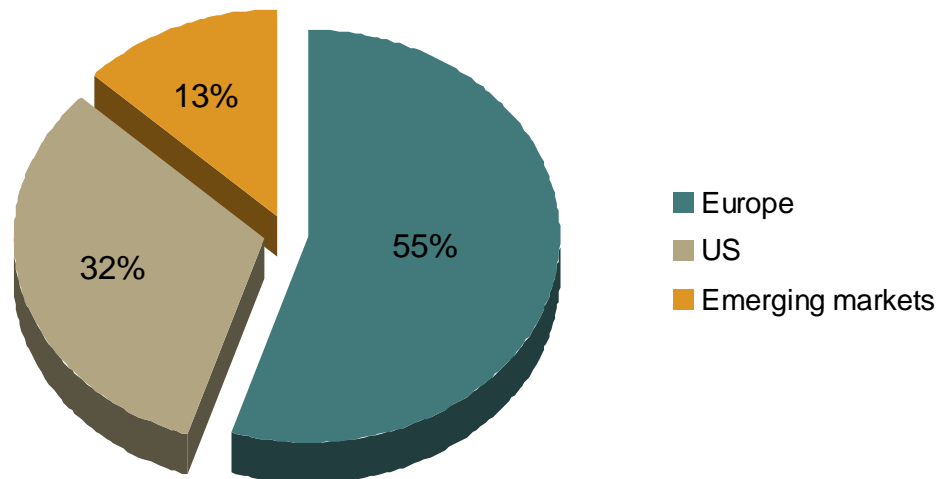
Will Rhoads
Analyst

LCH.Clearnet and Chi-X Europe plan to launch a unique Contracts-for-Difference (CFDs/equity swaps) clearing service as a joint initiative in the fourth quarter of 2010, starting with FTSE 100 stocks.

Introducing centrally-cleared CFDs

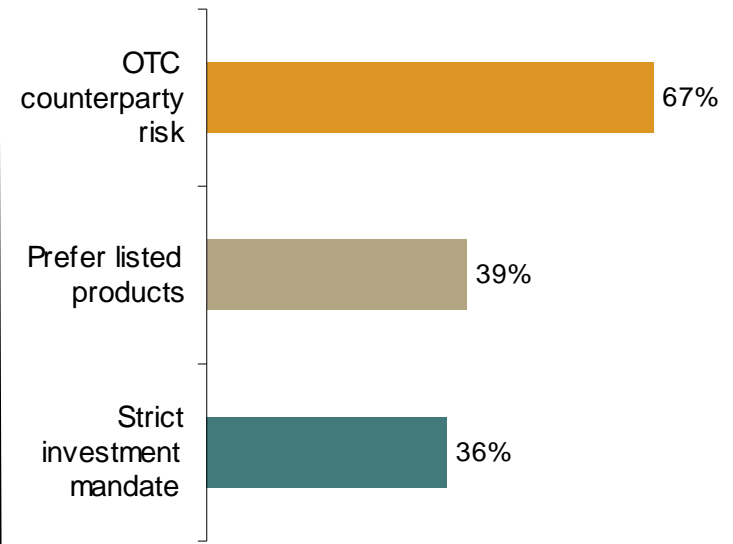
- ▲ A centrally cleared CFD (ccCFD) is a CFD/equity swap that is initiated as an over-the-counter (OTC) trade and is brought on-exchange and cleared through a central clearing counterparty (CCP) instead of as a bilateral agreement.
- ▲ ccCFDs are traded within the existing OTC CFD infrastructural framework; the CCP model makes the CFD a standardised product that can trade multilaterally between counterparties while retaining the efficiencies of the OTC trading element.
- ▲ The service aims to benefit from expected growth in CFDs, proposed regulatory changes, and address buy-side concerns over OTC counterparty risk.
- ▲ The ccCFD service is differentiated by its leverage of the current OTC execution model, which is venue agnostic on the equity hedge. Execution occurs OTC, the trade is brought on-exchange through Chi-X Europe and cleared by LCH.Clearnet. Financing and stock loan are provided through LCH via newly-created Allocated Clearing Members (ACMs)

Europe accounts for more than half of global equity swap volumes, with the UK CFD market making up the lion's share



Source: BIS, ISDA, TABB Group

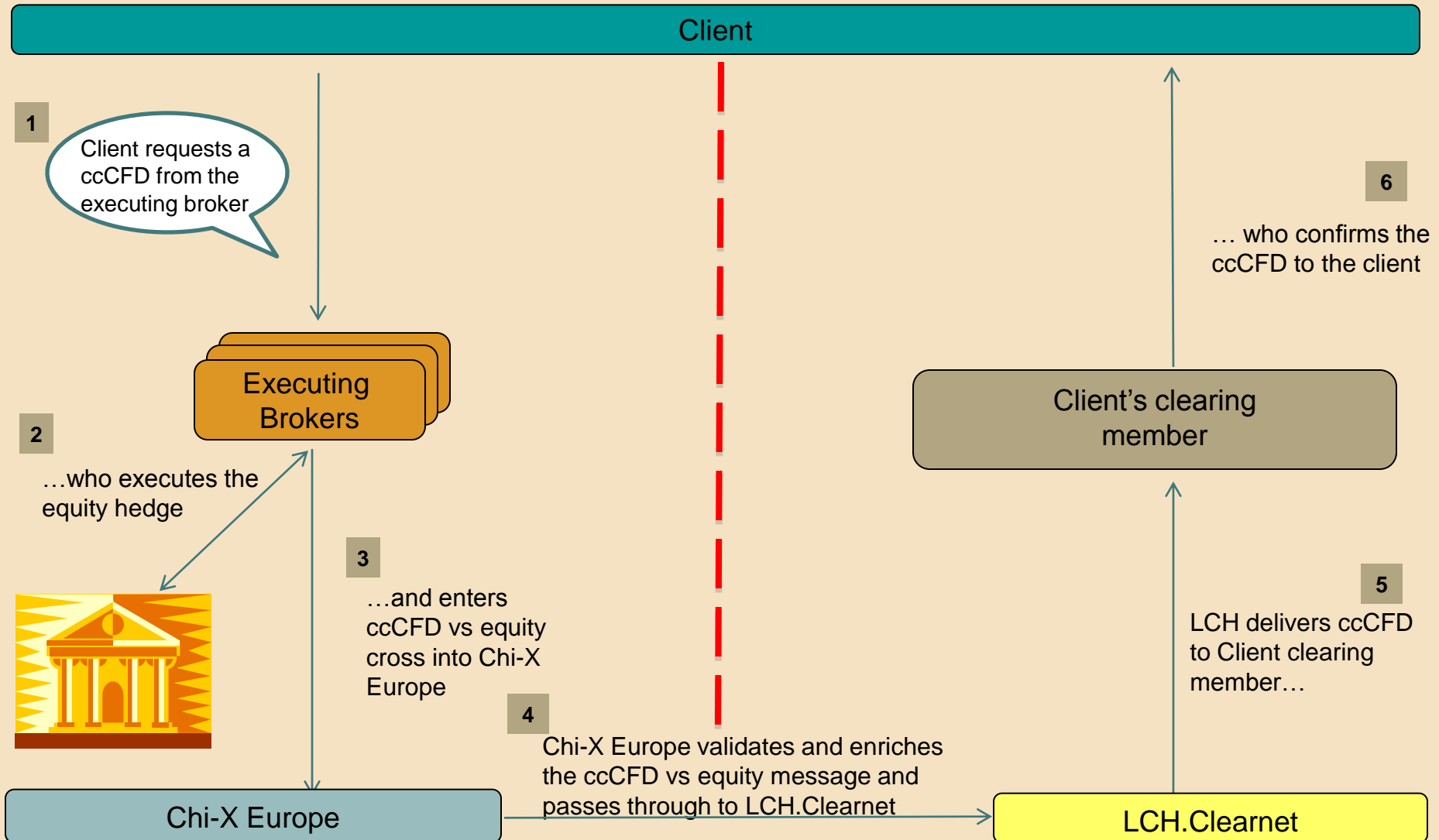
What restricts the buy side from trading OTC products such as CFDs in Europe?



Source: TABB Group

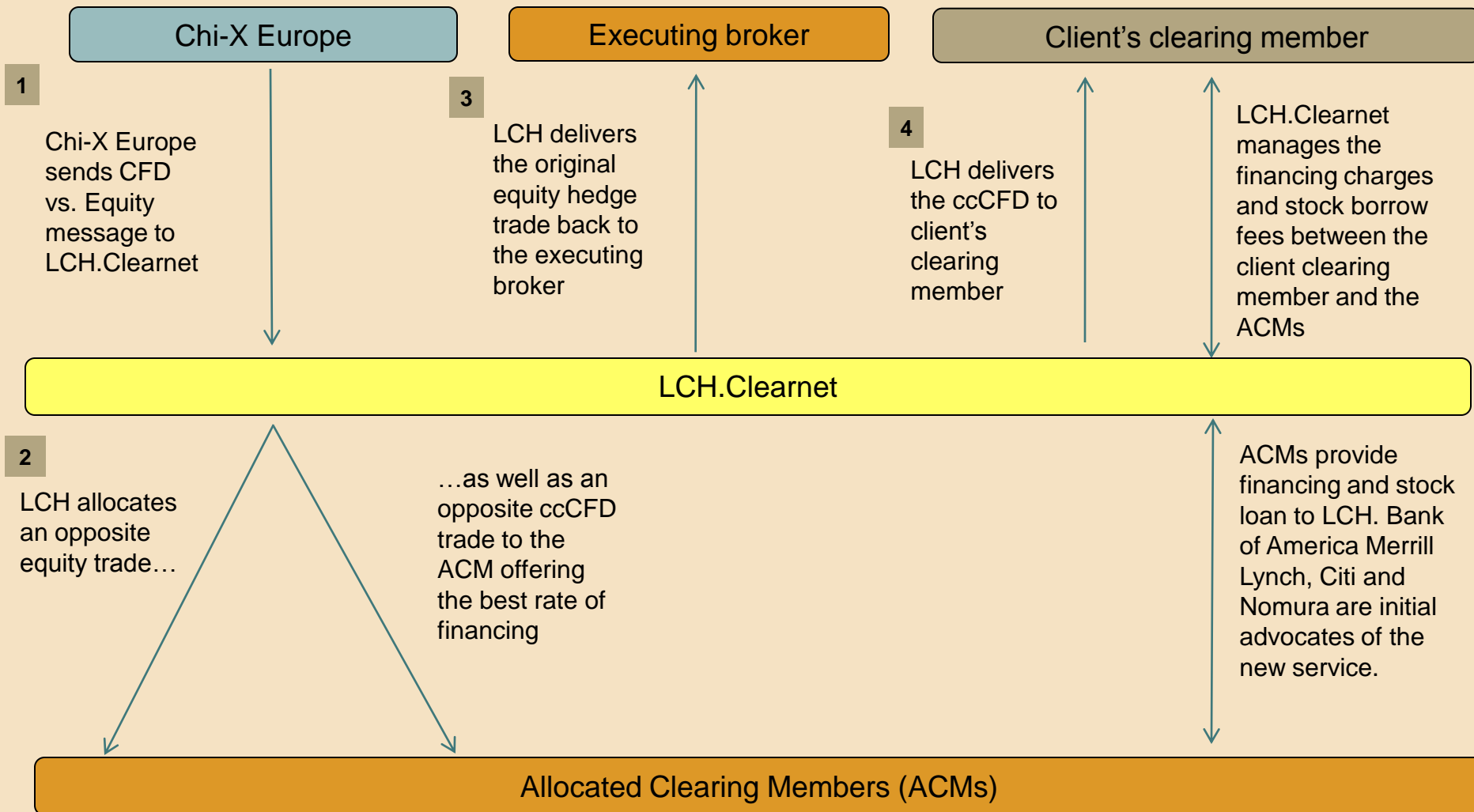
The primary differentiator is that ccCFDs are initiated OTC and brought on-exchange through Chi-X Europe and into central clearing via LCH.Clearnet.

ccCFDs – The Execution Process



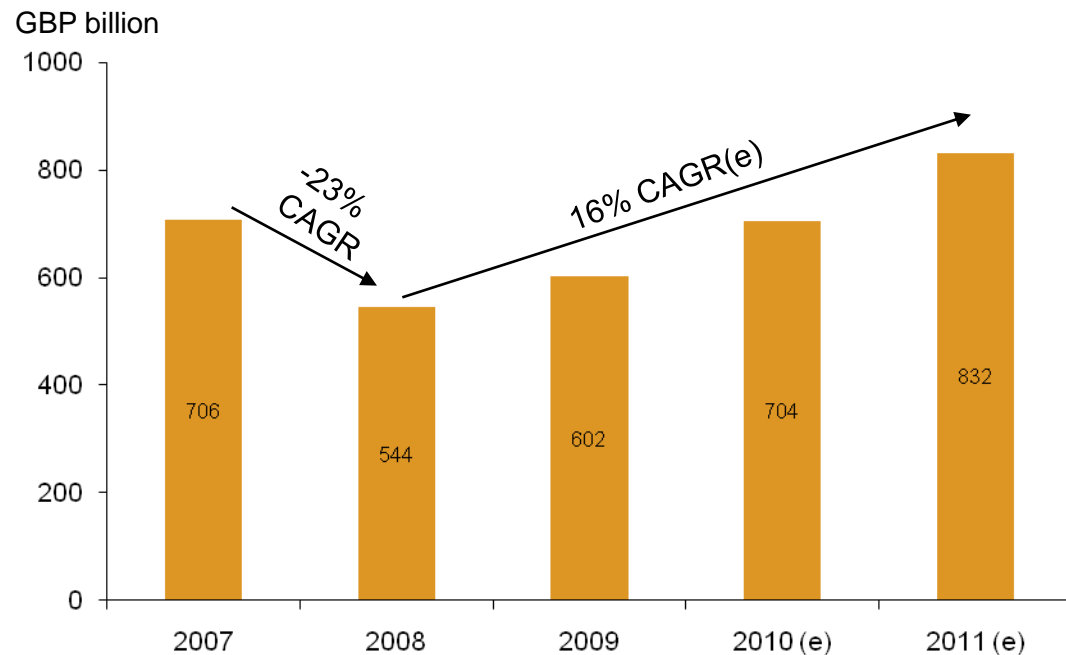
Margin, financing and stock borrow are separated out from execution and are operated by the client's clearing member.

ccCFDs – The Clearing Process



The ccCFD service offers significant advantages for both execution and clearing, and is being launched at a time of significant growth in CFD volumes.

Growth of the UK OTC CFD market (notional amounts)



Target audience

- ▲ UCITS III funds
- ▲ Retail aggregators
- ▲ Long-only asset managers
- ▲ Statistical arbitrage hedge funds

▲ ccCFD positions can be converted into equity and vice versa, delivering the same level of flexibility as the OTC market.

▲ The prime broker relationship changes to a simple clearing relationship, since ccCFDs are ordered through an executing broker. This is a major plus for those looking to avoid the cost of a multiple prime broker relationship.

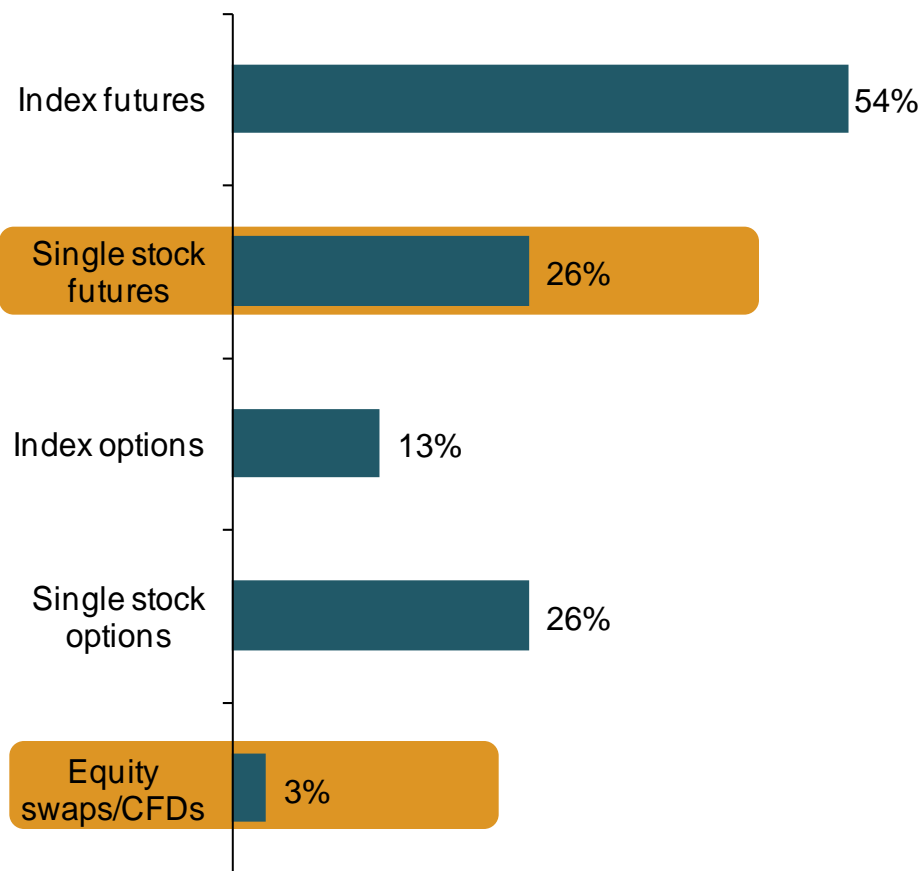
▲ With margins, financing, stock loan and ccCFDs all passing through LCH.Clearent there are cross-margining and netting efficiencies that can be brought to the model and passed through to the client in terms of competitive rates, lower margins and reduced transaction costs.

▲ ccCFDs bear many of the hallmarks of an exchange-traded product such as formally issued ISINs, standardised contracts, multilateral trading and central clearing.

▲ The service does not depend on drawing liquidity away from the OTC markets into an order book. ccCFDs are still initiated OTC and are brought on-exchange by marrying the ccCFD against the equity hedge, which is separately executed. This preserves the best execution of the OTC market by leveraging the existing equity market's liquidity, and offering a model that works with the OTC market rather than looking to replace it.

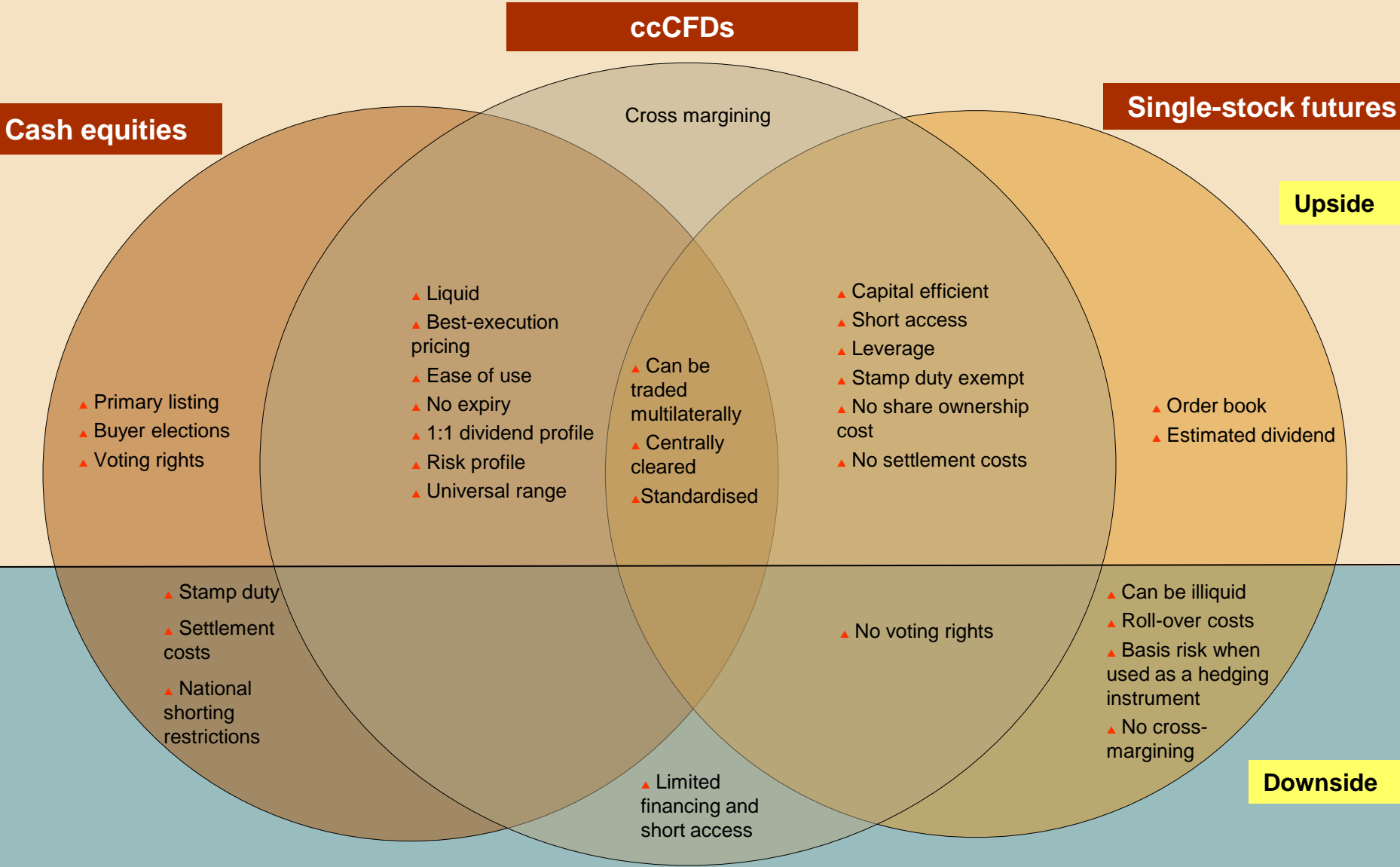
Long-only asset managers who currently use single-stock futures will be drawn to the new ccCFD service because it provides an additional risk management tool that should fit with their fund mandates.

Derivatives that asset managers trade the most



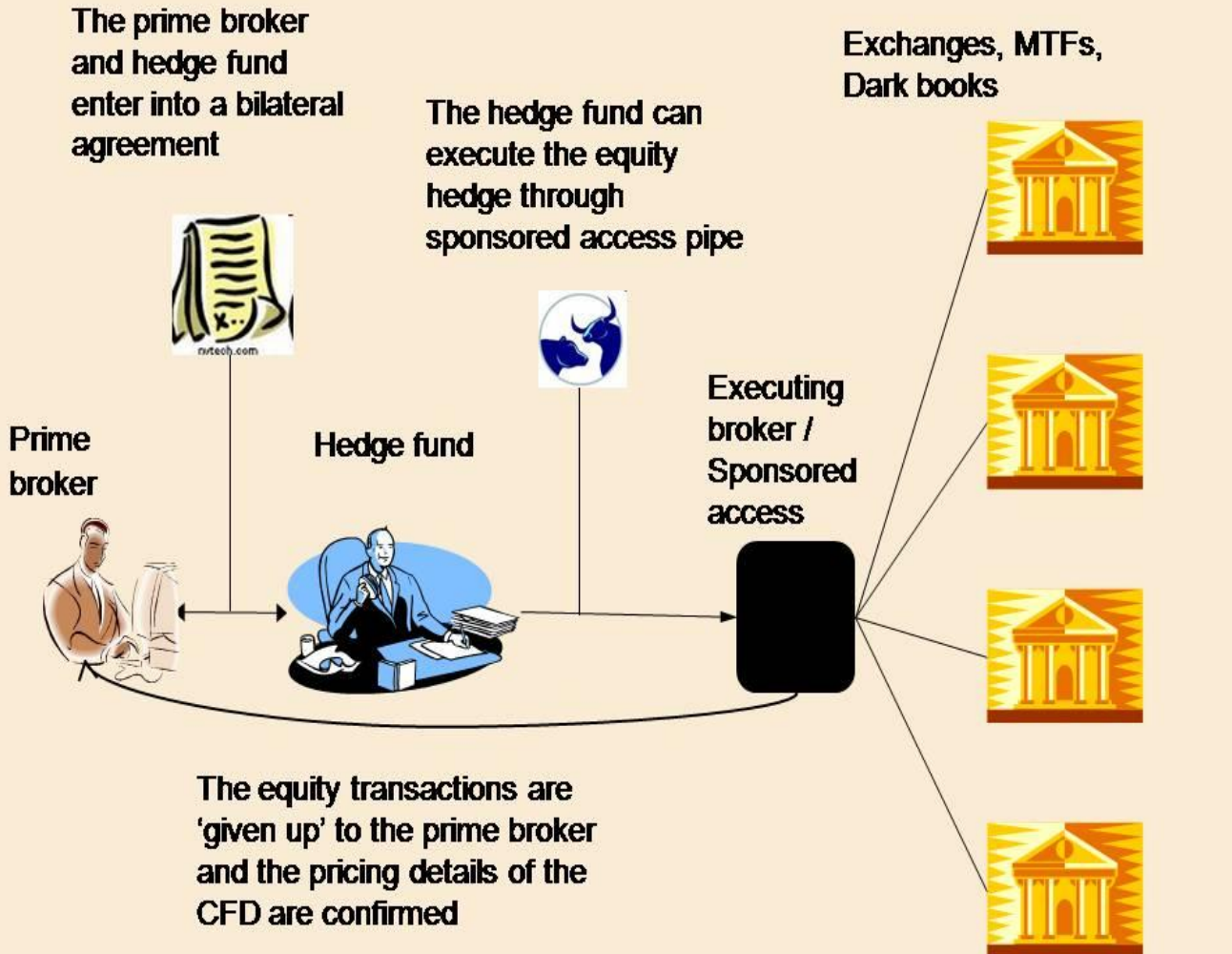
- ▲ While the new service will not have a formal exchange listing, it does offer a wholesale, standardised CFD product within a CCP model with complete post-trade transparency.
- ▲ The unique structure of a ccCFD should be sufficient to meet most fund mandates because the ccCFD and equity leg of the transaction brings the product on-exchange. But in instances where mandates specifically only allow for the use of exchange-traded products, ccCFDs present traders with a compelling argument to see the mandates amended to include the new product.
- ▲ Although the ccCFD transaction begins as an OTC order, the corresponding equity hedge is traded on the various exchange markets, which provides pre-trade transparency and best-execution pricing to the ccCFD trade. This is a unique characteristic of the ccCFD model whereby the ccCFD is intertwined between the underlying equity and a stand-alone derivative.

A ccCFD has broad appeal as it is effectively a hybrid product that sits between an equity and a single stock future.



Statistical arbitrage funds will also be drawn to the ccCFD service as it will offer tax certainty around the OTC give-up process, though frictional costs exist.

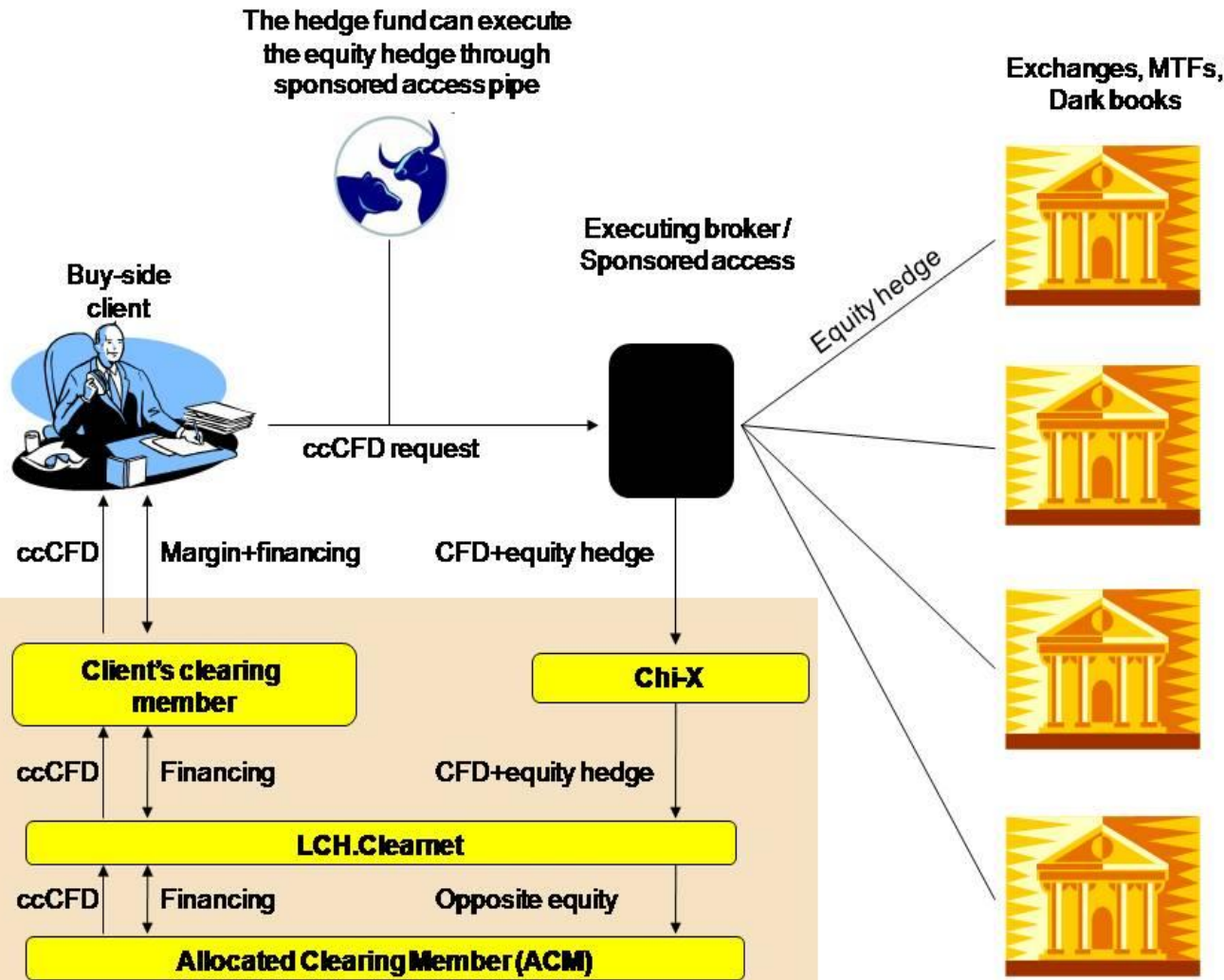
Best execution in the CFD market



- ▲ ccCFDs will effectively eliminate tax uncertainty surrounding the OTC give-up process, whereby statistical arbitrage funds use CFDs to flip in and out of equity positions on which they could be liable to pay stamp duty.
- ▲ The ccCFD service has the approval of HM Revenue & Customs and thus the service effectively legitimises tax uncertainty surrounding the OTC give-up process.
- ▲ Using smart order routers, statistical arbitrage funds typically execute the associated equity hedge themselves and have it 'given-up' to the prime broker they purchased the CFD from in order to avoid taking delivery of the stock and becoming liable to pay stamp duty.
- ▲ ccCFDs will however entail additional frictional costs. There are also question marks over the level of appeal among pan-European funds for a service that will only initially target liquid UK and European securities.

Indeed, best execution on the equity hedge for ccCFDs is a critical component of the new service offering a complimentary service to current OTC CFDs.

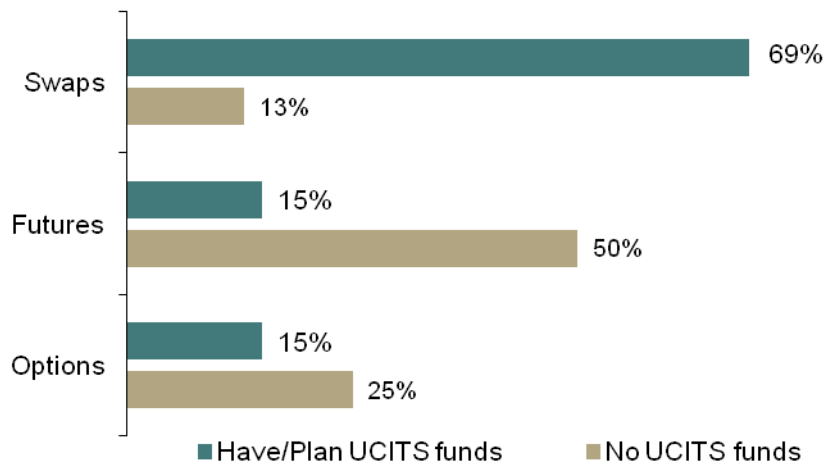
Best execution on the equity hedge in the ccCFD market



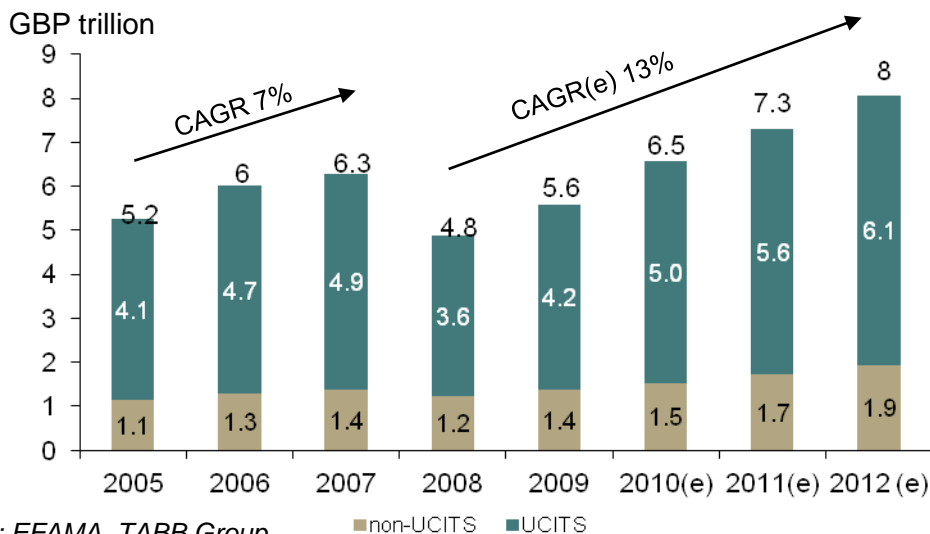
- ▲ Under the CCP model, best execution on the hedge operates in the same way as in the OTC CFD market but the CFD is brought on-exchange and centrally cleared.
- ▲ LCH provide financing and margin via the client's clearing member, not the prime broker. Financing is sourced from the ACMs.
- ▲ Having a Best Execution facility is the key differentiator between this service and a previous proposal to list CFDs.

Those hedge funds and long-only asset managers that have launched UCITS III funds will also use the service since a CCP model will mitigate existing counterparty credit restrictions when trading OTC derivative products.

Those with UCITS III funds use CFDs for synthetic short exposure



Funds under management in the European investment fund industry



Source: EFAMA, TABB Group

- ▲ Undertakings for Collective Investments in Transferable Securities III (UCITS III funds), which use OTC CFDs for synthetic short exposure, will favour ccCFDs for reduced counterparty credit risk.
- ▲ OTC CFDs are an approved product under UCITS legislation to gain short access.
- ▲ But UCITS funds are not permitted to take on more than 5% of the net asset value (NAV) of the fund to a counterparty when trading OTC derivatives such as OTC CFDs.
- ▲ Under the CCP model, UCITS III funds will be free to use ccCFDs without counterparty credit risk considerations and investment constraints.
- ▲ And as growth in UCITS III funds continues, TABB Group expects a corresponding increase in the use of ccCFDs by such funds.

However, large long/short hedge funds and absolute-return hedge funds, which make up the bulk of the existing market, will not initially use the service.

▲ Use is less likely because a CCP model introduces anonymity and eliminates the special relationship large hedge funds currently enjoy with incumbent prime brokers providing OTC CFDs.

▲ The existing relationship delivers favourable financing rates and stock borrow rates, as well as access to difficult-to-borrow stock in stressed market conditions because hedge funds can:

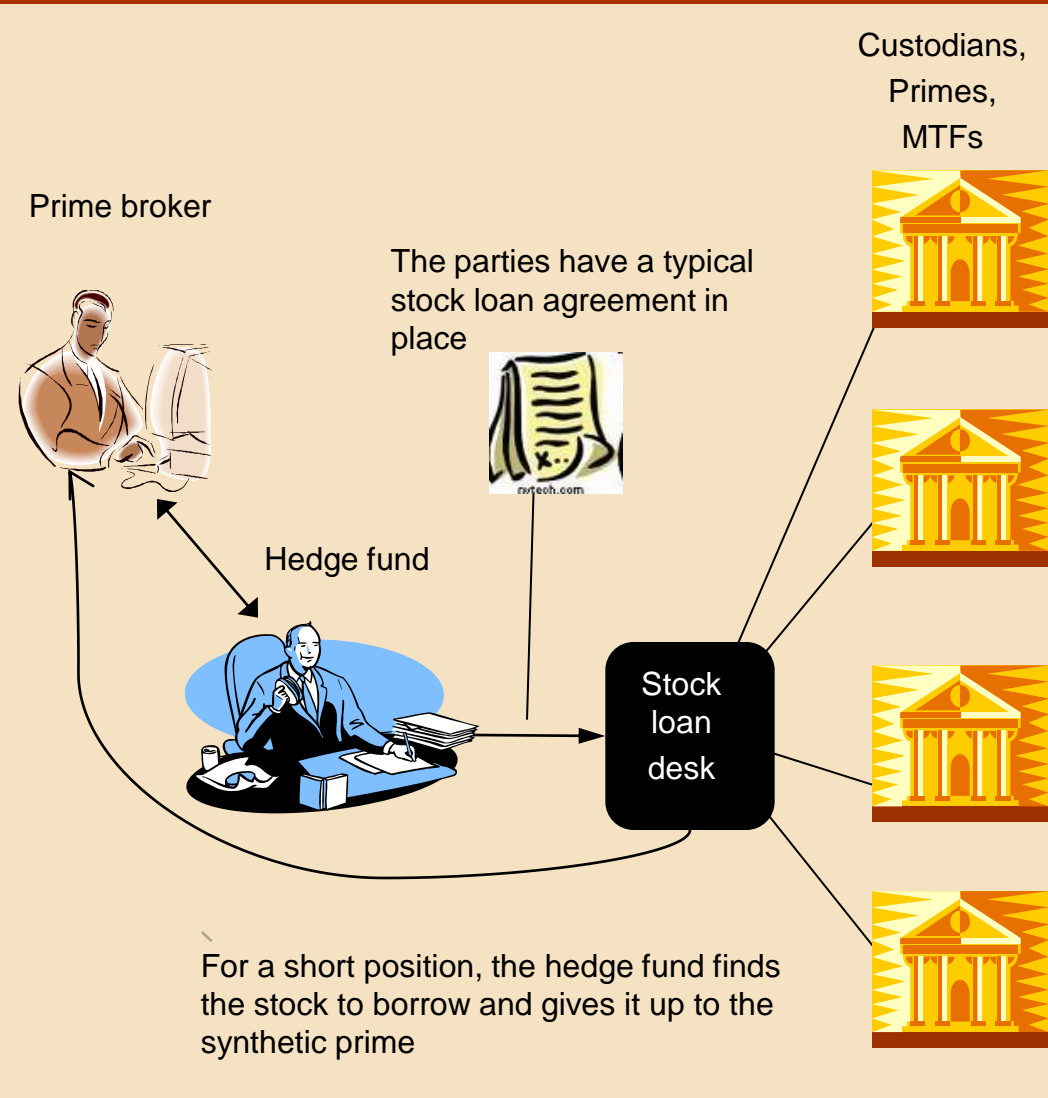
- ▲ Demand tight prices from prime brokers
- ▲ Source their own inventory of stock and instruct the prime broker to have it delivered on a 'put-through'.

▲ Since ccCFD trading will be anonymous, there will be no avenue for special treatment.

▲ Under the CCP model, spreads on stock borrow rates for stocks experiencing high stress may be quoted at high levels due to liquidity issues around borrow availability, effectively forcing the relevant stock off the ccCFD market.

▲ Hedge funds will also be deterred by the fact that the service resets prices and rates on a daily basis, which will increase operational costs and could have negative tax implications for those that seek to amortise trades to suit their P&L profile.

A disintermediated put-through in the CFD market



Adoption rates will vary between buy-side firms, with UCITS III funds and retail aggregators being prime movers.

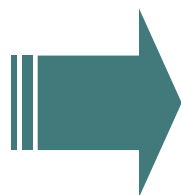
Buy-side type	Adoption rate	ccCFD service – Pros	ccCFD service – Cons
UCITS III funds	Prime mover	<ul style="list-style-type: none"> ▲ Mitigates restrictions on risk exposure to a single OTC counterparty below 5% of NAV ▲ Mitigates counterparty risk 	<ul style="list-style-type: none"> ▲ May seek greater depth of service beyond the more liquid UK and pan-European shares
Retail aggregators	Prime mover	<ul style="list-style-type: none"> ▲ Eliminates expensive prime broker relationship and reduces margin requirements ▲ Mitigates possible future regulation requiring CFD providers to set aside additional risk capital ▲ Daily reset matches their risk profile 	
Long-only asset managers	Interested but will wait and see	<ul style="list-style-type: none"> ▲ Wholesale, standardised CFD product in a central clearing counterparty model that could meet fund mandates 	<ul style="list-style-type: none"> ▲ Will require an OMS/EMS systems change
Statistical arbitrage hedge funds	Interested but will wait and see	<ul style="list-style-type: none"> ▲ Will eliminate tax uncertainty surrounding the OTC give-up process ▲ Product standardisation makes electronic trading of ccCFDs likely 	<ul style="list-style-type: none"> ▲ Frictional costs will be an issue ▲ May seek greater depth of service beyond the more liquid UK and pan-European shares
Long/short and absolute-return hedge funds	Will only move if forced to by regulatory change	<ul style="list-style-type: none"> ▲ Removes multiple Prime broker relationships per hedge fund, which is inefficient and expensive, while providing access to one standardised CFD via multiple brokers and a combined pool of financing liquidity 	<ul style="list-style-type: none"> ▲ Does not maintain the special relationship to the prime broker that is leveraged to ensure supply of stock during stressed market conditions ▲ Daily reset of rates and prices pose an operational challenge ▲ Inability to tailor bespoke products

European regulators may be on the verge of forcing OTC CFDs into a CCP model, which will force the hand of the hedge funds – in which case, the timing of the new ccCFD service will be impeccable.

Authority

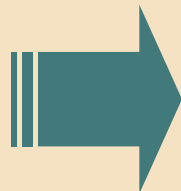
Influence

G-20 Leaders



“All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”

**Patrick Pearson,
head of EC reform
of Derivatives and
Market
Infrastructure**



There has been a *“notable absence of discussion about whether a CCP should be strong enough to withstand financial Armageddon”*.

**Sharon Bowles,
European Parliament’s
Economic and
Monetary Affairs
Committee Chair**



“I am in frequent contact with Gary Gensler [chairman of the US Commodity Futures Trading Commission] and Barney Frank [chairman of the House financial services committee], we email each other too. Of course we won’t say it [legislation] in the same way but I bet you we won’t end up being too far apart.”

European regulation on OTC derivatives, central counterparties and trade repositories

The September 15 proposal states that mandatory CCP clearing for eligible OTC derivatives will be enforced. To determine eligibility, the regulation introduces a ‘*top-down*’/‘*bottom-up*’ approach in which the European Securities and Markets Authority (ESMA) will force OTC derivatives into clearing based either on its own findings, or upon demonstration by a CCP that clearing is possible. In order to encourage product standardisation and, in turn, clearing, capital requirements will also make it more expensive to offer derivatives in the OTC market.

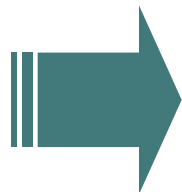
There are at least four major rule changes in the pipeline that could act as a catalyst for a wholesale shift to the ccCFD service.

Regulation

Focus

Driver

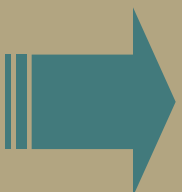
The Markets in Financial Instruments Directive (MiFID) Review



Deals with Best Execution, transparency and execution venues. May be extended to cover derivatives as well as equities.

- ▲ There is as much emphasis in Europe on Best Execution as there is on counterparty credit risk. A ccCFD service that delivers Best Execution in a clearing counterparty model delivers the best of both worlds.

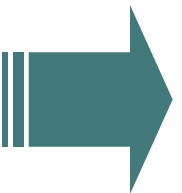
European Regulation on OTC Derivatives, Central Counterparties and Trade Repositories



Legislation for mandating central counterparty clearing (CCP) for eligible derivatives contracts.

- ▲ Previous EC documentation classifies CFDs as 'eligible derivative contracts'.
- ▲ Demonstration that CFDs can be cleared may prompt ESMA to force EU-wide legislation for the product.

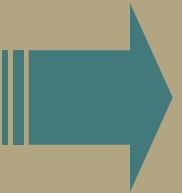
Alternative Investment Fund Managers (AIFM) Directive



Places restrictions on European institutional investment in offshore hedge funds and restricts hedge funds from marketing themselves on the Continent.

- ▲ European fund managers would no longer be able to invest in 40% of non-EU hedge funds.
- ▲ By setting up UCITS III funds, hedge funds will be able to bypass the effects of the Directive.

Capital Requirements Directive



Places requirements on users and providers of OTC derivatives to set aside risk capital provisions.

- ▲ Will have a significant impact on retail aggregators who sell CFDs to the retail market, particularly those who do so without hedging.
- ▲ A CCP model will mitigate the need to set aside risk capital and reduce potential impact on profits.

Source: TABB Group

As with any new service, there are challenges, but the opportunities and ambitions for the new offering remain high.

Opportunities

- ▲ The product suits multiple audiences within the buy side and is equally attractive to sell side houses looking to create new revenue streams.
- ▲ Long-only asset managers are on the prowl for alpha and risk management tools; retail aggregators face possible capital adequacy regulation; UCITS III funds seek counterparty credit risk mitigation models; and statistical arbitrage hedge funds are looking for tax certainty.
- ▲ The door is open for brokers to compete. While only three ACMs will begin offering financing and stock inventory, there is the option for more to join.
- ▲ The ccCFD is a standardised contract so multiple brokers can offer the ccCFD and LCH will net the resulting positions.
- ▲ There is strong potential beyond UK shores as the initiative will be rolled out down the UK list and to pan-European shares.
- ▲ There is a sense of 'inevitability' to the launch especially given the regulatory changes on the horizon.

Challenges

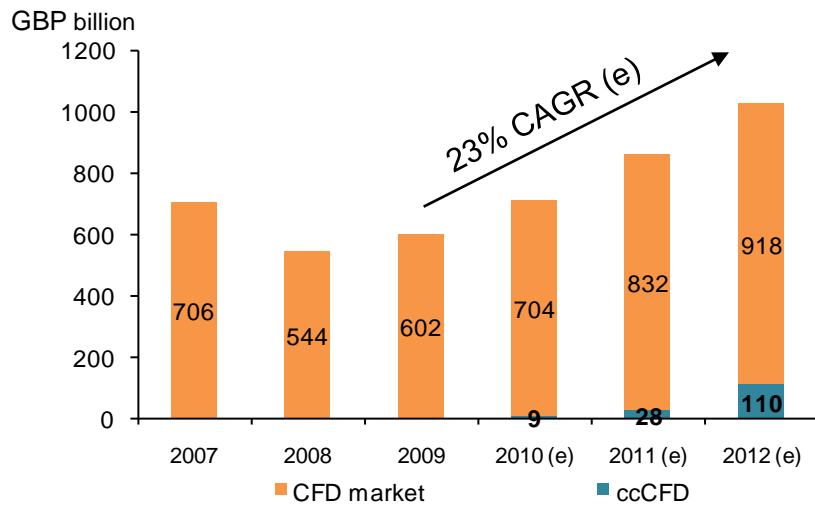
- ▲ This is a new product and therefore will need to prove its value against existing products, as well as incumbent OTC CFD providers who may not be receptive to change.
- ▲ Initial take-up may find a limited audience, as those who seek a global CFD service require the widest range of securities.
- ▲ Price will always be key. Large hedge funds are used to obtaining the lowest possible, long-term fixed financing rates, so the ccCFD service will need to produce extremely competitive spreads to attract this flow.
- ▲ Systems changes will entail either the purchase of a pre-existing CFD system (from a vendor or a prime broker) that have been adapted for the ccCFD product or the possible roll-out of pre-existing equity systems to include ccCFDs.
- ▲ While the service is not dependent on attracting volume for success, volume nevertheless begets volume since the undecided will only be drawn to the service if it is 'seen' to be successful.

Conclusions



The depth and breadth of regulatory change will effect the speed of adoption of the service. Two scenarios are possible: regulation will, or will not, force CFDs into a CCP model.

CFD notional amounts (no regulatory change)

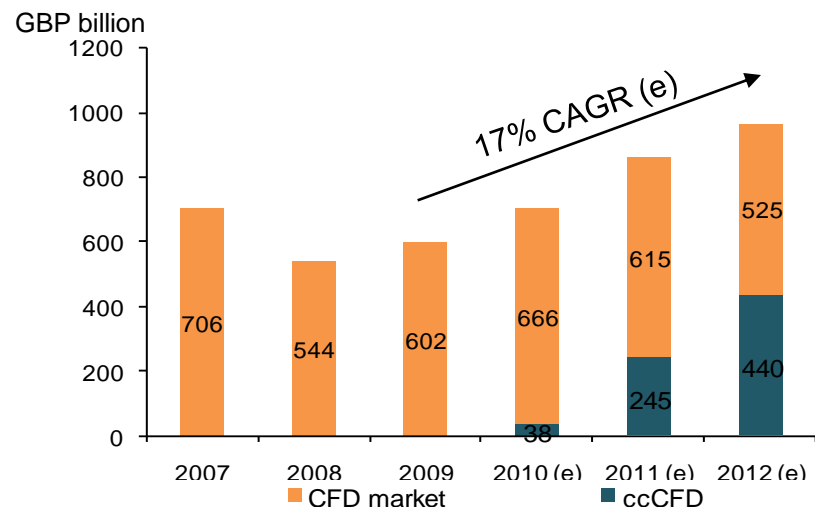


Likely impact of the service on the market and market participants....

... if CFDs are not forced into a CCP model

- ▲ ccCFDs will add to the size of the overall CFD market, as it widens the product appeal to a broader range of investors, such as long-only asset managers.
- ▲ TABB Group expects ccCFDs to boost the overall CFD market at a CAGR of 23% (up from 16%), with notional amounts reaching GBP1.1 trillion by 2012.
- ▲ Capital adequacy regulation will nevertheless make it more expensive to provide CFDs in the OTC market and ccCFDs are set to become an increasingly attractive alternative.

CFD notional amounts (with regulatory change)



... if CFDs are forced into a CCP model

- ▲ ccCFDs will ultimately replace the existing OTC CFD market.
- ▲ While TABB Group would expect a lower CAGR of 17% in this instance (as large hedge funds seek out alternative instruments), the ccCFD share of the marketplace will increase dramatically, reaching GBP245 billion in 2011 and GBP440 billion by 2012.

Centrally cleared CFDs are not a pipedream – they are an inevitability. Chi-X Europe, LCH.Clearnet & the ACMs are committed to the launch and there will be no about-turn.

Likely impact of the service on the market and market participants (continued)

Consequences (intended and unintended)

- ▲ The regulatory wind is in the sails for CFDs to move to a central clearing counterparty model and – if European regulators do mandate such a move, which currently looks likely – the service launch could not be better timed. Indeed, there is a sense of ‘inevitability’ to the launch, given the current regulatory environment.
- ▲ Nevertheless, LCH.Clearnet stresses that the service stands on its own merits regardless of regulatory change. That may be true for new users of the CFD product, mid-sized hedge funds and retail aggregators, but it is less so for large hedge funds and the incumbent CFD providers. For them to move quickly to the ccCFD service, their hand will have to be forced.
- ▲ In the absence of regulatory change, success will depend on competitive pricing, ability to attract volume from retail aggregators, as well as a willingness from long-only asset managers and hedge funds to introduce operational and systems changes.
- ▲ Some long-only asset managers may seek to amend fund mandates in order to accommodate ccCFDs.

Winners and Losers

- ▲ Prime brokers will see competition and their margins potentially eroded.
- ▲ The clearing divisions at banks will take on a primary function in ccCFD trading.
- ▲ If the product is successful, launching executing brokers and clearing members will have first-mover advantage over their competitors.
- ▲ Chi-X Europe and LCH.Clearnet will enjoy first-mover advantage on the service offering.

Expected changes

- ▲ The service is set for a soft launch in the fourth quarter as first adopters and ACMs ‘test’ the waters, and it will likely not ramp up until the first quarter of 2011.
- ▲ TABB Group expects that the success of the service will be heavily influenced by the extent of impending regulation, which we expect will either see OTC CFDs forced into the clearing model or, at the very least, it become more capital intensive (expensive) to provide OTC CFDs.

A hand holding a compass over a body of water. The background is a blurred view of water and a horizon line under a teal sky. The hand is in the foreground, holding a small, round compass. The overall tone is warm and professional.

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