

# Derivatives Week

The Weekly Issue from Derivatives Intelligence [www.derivativesintelligence.com](http://www.derivativesintelligence.com)

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Santander has hired **Nick Fuller**, the co-head of equity single stocks trading at **Royal Bank of Scotland** in London, in a similar role.

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## Top Stories

### HK Legislators Nix Structured Product Investor Rules

Hong Kong's **Legislative Council** has rejected proposed changes to the Securities and Futures (Professional Investor) Rules aimed at introducing amendments to improve protection for investors in structured products.

The council rejected the amendments two weeks ago after they were introduced by **Kam Nai-wai**, the legislative council member for central and western Hong Kong Island. The amendments would have added accreditation requirements for investors, mirroring recent changes to

*(continued on page 12)*



### Funds Scoop Novel EUR/USD Window Barriers

Hedge funds have been buying exotic window barrier puts on the euro/U.S. dollar cross over the past two weeks. They're positioning for the euro to stay strong over the short-term but depreciate over the medium-term.



A window barrier is when an investor picks a strike for a particular tenor and then a partial barrier knock-out level or levels with a shorter tenor. If the option passes the shorter tenor without breaking the barrier knock-out level or levels, the "window" for a knock-out event closes, meaning the option becomes vanilla and the strike becomes the reference level for profit.

In current trading, hedge funds have been buying three-month put

*(continued on page 12)*

### ESMA Group Pushes ETF Policing Overhaul

The **European Securities and Markets Authority's** influential Securities and Markets Stakeholder Group has called for radical changes to the way physical and synthetic exchange-traded funds are regulated. It wants more power for ESMA and is considering a ban on selling synthetic ETFs to retail investors.

In advice to ESMA in a document, the SMSG agreed with the regulator that changes should be made to the way ETFs are regulated, including adding identifiers in their titles, requiring greater disclosure in synthetic ETFs related to underlying exposure and counterparties, and enforcing stricter requirements for collateral. The advice was submitted as **Steven Maijor**, chair of ESMA, last week said the regulator was determined to introduce a better framework for investors in ETFs. Officials expect the regulator to take on board the

*(continued on page 11)*

## At Press Time

# RBS Equity Trader Joins Santander

**Nick Fuller**, the co-head of equity single stocks trading at **Royal Bank of Scotland** in London, has joined Santander in a similar role also in London.

He joined a few weeks ago, reporting to **Sunil Ahuja**, head of derivatives and U.K. operations in London.

At RBS, Fuller was responsible for developing the single stock business alongside **Marc Baylis**, hiring individuals such as **Laurence Verghese** from **CBIC World Markets**. Fuller joined RBS in 2005 from **Goldman Sachs**, where he worked in single stocks trading covering the U.K. and Germany.

Fuller confirmed his appointment.

# Citi Cuts Three In EQD

**Citigroup** has cut three in its equity derivatives group: **Adrian Jones**, a v.p., **Camellia Lowry**, a director, and **Amrish Pattni**, whose title could not be gleaned. All three were let go two weeks ago. Specifics on their plans could not be immediately gleaned.

Jones was an equity derivatives trader, as was Pattni. Lowry was in equity derivatives sales. Jones and Lowry declined comment when reached by cell phone. Pattni could not be reached.

Lowry had been a director with the firm since 2000. Before that she worked for **Chase** for three years in equity derivatives sales, according to her LinkedIn profile. Pattni joined Citi in 2010. Jones' history could not be immediately determined.

A spokesman declined comment.

# EUR/CHF Exotics Sought...Rebuffed

Hedge funds have been trying to structure exotic structures on the euro/Swiss franc with the expectation that the **Swiss National Bank** will re-peg the franc at 1.25 or 1.30 at its next meeting Dec. 15. Dealers are refusing to create the plays due to the lack of interbank appetite.

"Hedging an exotic structure in the interbank market looks appalling," said one trader in New York. "We're quoting vanilla options but exotics would be too difficult."

Another structurer based in Stamford, Conn. said the firm's desk had received inquiries for long EUR/CHF plays but could not enter into the trade since it would be unlikely that another dealer would be counterparty to hedge. Vanilla options traded in the pair have been at-the-money straddles around the CHF1.25 mark, said traders in London and New York.

**Sebastien Galy**, fx strategist at **Société Générale**, wrote the odds of a move by the SNB have increased considerably. He cited the possibility of "a hit on growth and inflation" in the local economy, along with the decreasing odds of the eurozone falling apart as reasons the SNB may re-peg the franc.

The SNB will meet Dec. 15 for its quarterly assessment on monetary policy. Three months ago the central bank said it regards the currency as massively overvalued and is aiming for a substantial and sustained weakening of the franc.

## Tell Us What You Think!

Questions? Comments? Criticisms? Do you have something to say about a story that appeared in *DW*? Or is there information you'd like to see published? Managing Editor **Robert McGlinchey** can be reached at (44-20) 7303-1789 or [RMcGlinchey@euromoneyplc.com](mailto:RMcGlinchey@euromoneyplc.com).

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Intelligence

## AMF's Jouyet Urges Reg Powers For MiFID

The **European Securities and Markets Authority** along with national regulators should be given the appropriate resources and powers to enforce the requirements outlined in the updated Markets in Financial Instruments Directive, according to **Jean-Pierre Jouyet**, chairman of the **Autorité des Marchés Financiers**.



In a speech to the European Parliament's Economic and Monetary Affairs Committee last month, Jouyet noted that regulators should be given the necessary resources to access trading platform order books and regulate high frequency trading. Under the MiFID proposals from the **European Commission**, regulators will be given the powers to restrict and even ban products.

"At present, price manipulation occurring on several platforms

at once goes undetected and hence unpunished," said Jouyet. "Furthermore, the requirements applicable to platforms must be aligned at a high level. Unlike regulated markets, alternative platforms, known as multilateral trading facilities, are not currently required to supervise the trades they execute."

**Verena Ross**, executive director of ESMA, noted that resources will be allocated to the regulator once MiFID is implemented. She added, however, that getting the right resources will be challenging, noting that building the right I.T. systems and infrastructures to survey the market will be difficult to implement.

Jouyet added that ESMA should be given broader powers to regulate high frequency trading, such as in platforms' pricing or ticket sizes. He also noted that a marking requirement should be introduced that would allow regulators to determine which transactions should not be opaque.

MiFID is aimed at improving the oversight of less regulated markets that includes increasing derivative transparency through the introduction of organized trading facilities and addressing excessive price volatility in commodity derivatives, for example.

The ECON committee is evaluating proposals from the Commission and is expected to issue a legislative report on the issue early next year.

## Swap Costs Still A Hurdle For U.K. Issuers

The cost of foreign exchange swaps for certain U.K. firms looking to issue securitizations into the U.S. and Europe beyond the core U.K. investor base remain "prohibitively" expensive, according to **Stephen Bowcott**, head of securitization at **Paragon Group**.

Speaking at a panel session on funding options for mortgage originators at **Terrapinn's Securitization World 2011** conference in London last Monday, Bowcott said there is a "natural progression" for issuers to look beyond the U.K. to tap investor appetite.

But swap costs are proving "prohibitively" tough, he said, with issuing firms having to price in these "significant" costs to the spreads paid on bonds. "It means paying a large chunk, in cost terms, for an FX swap," Bowcott told delegates.

Paragon, a U.K. buy-to-let residential mortgage issuer that printed its GBP163.8 million (USD256.3 million) comeback RMBS Paragon Mortgages No. 16 last month, is funded wholly by securitization. The firm had previously been a regular issuer in the RMBS markets prior until the 2008 crisis shut down its lending activities, with its last deal, the GBP1 billion (USD1.56 billion) Paragon No. 15, coming in June 2007. Bowcott said the firm's funding capability is affected by the volatility in securitization pricing. "It is challenging to get the margins going forward in order to achieve funding."

The relatively small size of Paragon's recent buy-to-let RMBS did not merit a euro or dollar denomination, he noted, but with the majority of its legacy portfolio denominated in euros or dollars, the firm continues to maintain dialogue with U.S. investors.

"The U.K. investor base is a finite size and Solvency II

[regulations] is not going to help. We need to look further afield to get volumes," he added. "I'm not sure if the securitization market or swap market will get better in terms of pricing. We need to get the pricing on the assets to improve but that might not improve any time soon either."

## Users Seek Clarity On Clearing



Luke Zubrod

Clearing is among the top concerns for financial end users, according to **Luke Zubrod**, director of regulatory compliance services at Kennett Square, Pa.-based risk advisory firm **Chatham Financial**. Users, like regional banks, are looking for more clarity from regulators on the kinds of technology, documentation and margin requirement

they are supposed to follow when transacting with non-financial institutions.

On Dec. 6, Chatham released a series of guides for users. Among the main themes is what to do in the interim before Dodd-Frank rules are finalized. In one guide, Chatham advises financial institutions to "refrain from committing to any particular clearing member firm, especially since legal documentation for clearing may need to be modified depending on final rules."

Zubrod advises users to begin the process of considering which clearing houses might be most appropriate. He went on to say that there are two factors for financial end users to consider when choosing a clearing house. The first is that, absent solid regulatory rules, if a firm contracts with a clearing houses and members too early, it might not get optimal rates. "And the other is if we wait until the last minute there are going to be thousands of entities in line to

sign up with clearing houses and clearing members.”

Another issue on the minds of financial end users is the extra-territorial reach of Dodd-Frank. “There is now a hope from the end user community that there will be a separate rule that has not yet been put forth that would clarify the applicability of U.S. law when firms transact abroad,” Zubrod said. The **Securities and Exchange Commission** and the **Commodity Futures Trading Commission** are both considering rules to clarify extra-territorial issues.

## Tail Beta Analysis Yields Inexpensive Cross-Asset Hedges

Strategists at **Barclays Capital** have combined an analysis of tail beta, or the expected return of an underlying relative to the financial market as a whole, with a ratio of put prices to pinpoint inexpensive yet effective tail risk strategies for equity and credit portfolios.

Calculating a new way to hedge tail risk has been a focus of the industry as dealers and end users alike have recognized the relative expensiveness of holding a put option on the S&P 500, which is generally agreed to be an efficient way to hedge tail risk.

Underlyings outside of the U.S. equity space that fit the mold for an inexpensive hedge include the Turkish lira/U.S. dollar cross, the United States oil exchange-traded fund (USO), the Nikkei 225 index, and the S&P 500 Volatility Index(VIX). Within the U.S. equity space, the domestic financials, industrials, and utilities ETF's also provide inexpensive systematic hedges.

The strategists recommend using one month at-the-money put options on any of the underlying to implement an effective strategy. Notionals are adjusted by multiplying 0.33 times the calculated tail beta level. Tail beta levels are partially calculated by recognizing the correlation of an underlying to the S&P 500, wrote **Maneesh Deshpande**, equity strategist at the firm in New York.

## IOF Tax Repeal Spurs Brazil Trading Interest

Interest in derivatives trading of exchange-traded fund underliers referencing Brazil increased at the beginning of last week after the Brazilian government repealed a 2% tax on foreign investors trading the country's equities and a 1.5% tax on American Depositary Receipts. The tax, called IOF, stands for Financial Operations Tax.

On Dec. 1, when the tax was repealed, an investor bought USD150 million notional of call spreads on the iShares MSCI Emerging Markets Index Fund (EEM). The spreads were purchased with strikes at 42.00 and 45.00 maturing at the end of December for 41 cents a trade. The ETF was at 40.20 at press time.

A call spread means an investor purchases a set of options at a strike close to the money while selling the same number of options at a strike further away from the money, therein funding the

purchased options. An ETF trader in New York called the trades “quite significant.”

On the same day, strategists at **Société Générale** published a note recommending three separate over-the-counter trades on the iShares Brazil Index Fund (EWZ), including an exotic play wherein the investor goes long the EWZ via a call spread collar expiring in January with strikes at \$62.00, \$67.00, and \$51.00, which would have cost 61 cents on Thursday. The strikes were chosen at a ratio of 103%, 111%, and 85%, meaning the investor buys a call at 103% and sells a call at 111% and a put at 85%.

An official at SocGen told *Derivatives Week* the firm had seen short-term upside calls on the Brazilian ETF since the repeal, though no further details could be gleaned.

The 2% tax on foreign equity investments was launched in October of 2009 to help stem the appreciation of the real. The government repealed the taxes to encourage long-term foreign investment and shield the country from possible ill effects from the eurozone debt crisis. Brazilian finance minister **Guido Mantega** stressed that the government could reintroduce tax measures if speculative flows flood the country and boost the currency.

“We are not easing our currency policy. If there is any risk of the currency appreciating, we will increase the IOF on derivatives,” Mantega said at a press conference Dec.1.

## RBS Offers Euro Share Class CTA ETF

The **Royal Bank of Scotland** has launched a euro hedged share class synthetic exchange-traded fund linked to the RBS Market Access CTA Index, the first of its kind to be offered.

The euro share class ETF follows the launch of the U.S. dollar denominated RBS Market Access CTA Index ETF in September, which tracks the performance of commodity trading advisors. The euro share class ETF delivers the index performance in euros, and is hedged through rolling one-month foreign exchange forwards on the USD/EUR.



Andrea Sozzi Sabatini

“Some of our clients liked the concept behind the original dollar ETF but asked us to add a euro hedged version, which required some further work from our structuring team,”

**Andrea Sozzi Sabatini**, head of sales for Europe, the Middle East and Africa and Latin America, told *Derivatives Week*. “So we decided to first launch the U.S. dollar denominated ETF, then to launch the euro

hedged version. The reason was to have it on the street as soon as possible because most of the institutional investors wait 6-12 months after launch before investing.”

Sabatini said that both share classes of the ETF are likely to find favor among end users amid growing interest in the CTA industry, with an increase in capital inflows in CTAs in recent years. “We believe in this segment since it allows our clients to gain access to

a well-diversified pool of liquid, uncorrelated underlyings through a single investment in our ETF," he said.

He noted that it was difficult to use assets under management as evidence of interest, since asset managers and insurance companies, for example, have internal policies before investing in these types of products, which require them to wait to see the performance of the product for a period of between 6-12 months before investing.

The index is equally weighted between the RBS Systematic CTA Index and the RBS Discretionary CTA Index so to provide a full range of CTA strategies. Constituents in the Systematic CTA Index include **Blackwater Capital Management's** global program and **Altis Partners'** global futures portfolio, while the Discretionary CTA Index includes **Lubben Capital Management's** Lubben Program and **Global Ag's** Discretionary Trading Program. Both indices are reweighted monthly.

The ETF is UCITS IV-compliant and will trade on **Deutsche Börse**.

## News Clippings

News clippings includes stories from other news sources from around the market. *DW* does not guarantee the completeness or accuracy of the stories gleaned from other sources, though they are believed to be reliable.

- The U.S. **Commodity Futures Trading Commission** is planning to unveil a version of the Volcker rules that CFTC Chairman **Gary Gensler** said would be similar to those offered by other regulators. (*Reuters*, 12/6)
- **Deutsche Boerse** and **NYSE Euronext** are said to be considering a spin-off of some of their derivatives operations to satisfy **European Union** antitrust regulators that are to decide whether to approve their proposed merger. (*Dow Jones Newswires*, 12/7)
- Options trading in the U.S. rose by 10% in November, while European trading tumbled by one-third, as the gap in equities derivatives trading between the two regions widens, according to **NYSE Euronext**. (*Financial News*, 12/7)
- Claims on **Lehman Brothers'** derivatives unit will pay between 27.9 cents to 32 cents, compared with 48.4 cents to 44.7 cents on commercial-paper claims, according to the firm's liquidation approved by a bankruptcy judge. (*Bloomberg*, 12/7)
- **Citigroup** will eliminate roughly 4,500 positions, with its proprietary trading taking some of the hits as the bank is closing down operations that invest customers' funds, according to CEO **Vikram Pandit**. (*Bloomberg*, 12/6)
- The **Depository Trust & Clearing Corp.** has launched its global, over-the-counter interest rates derivatives trade repository. (*DTCC*, 12/7)

## Asia Pacific

### Singapore IRS Clearing Volumes Continue Decline

Clearing of over-the-counter interest rate swaps via **Singapore Exchange's** central clearing counterparty DerivativesClear saw a steep decline in November to SGD4.5 billion (USD3.5 billion) from SGD11.4 billion (USD8.9 billion) in October. Analysts noted the continuing possibility of negative interest rates and the traditionally slow end of year period had contributed to the low volumes.

A market official questioned whether SGX's CCP could sustain the lower levels of clearing. He said mandatory clearing of IRS and fx derivatives should help to increase the profits of the clearinghouse next year. However, if there is no volume traded, then mandatory clearing is not going to help the SGX make the CCP profitable, he said.

The swaptions market dried up in August, while the swaps market lost significant liquidity when interest rates moved into negative territory earlier in the year (*DI*, 9/5). This was reflected in the clearing of IRS via DerivativesClear, with volumes decreasing SGD10.5 billion (USD8.18 billion) to SGD22 billion (USD17.14 billion).

The exchange recently announced it will be expanding its clearing service to fx forwards next year (*DI*, 9/29). Interest rate swap clearing increased steadily through the year, with SGD33 billion (\$25.7 billion) in July, up from SGD14.2 billion (USD11.07 billion) in June when the exchange first started clearing IRS.

A spokeswoman from SGX did not immediately respond to phone calls or emails.

### SocGen Preps Asian ETF, Eyes De-Listing

**Société Générale** is developing two new Asian synthetic equity exchange-traded funds, while also considering whether to pull its Lyxor range of ETFs from the Hong Kong stock exchange.

**Herman Chan**, director and head of ETF distribution Asia

Pacific at SocGen's Lyxor division, said the firm is pressing on with developing a local Thailand index tracker ETF and an MCSI Indonesia ETF. "Whether the [delisting] is going to happen or not is still a big question mark," he noted. "The business in Asia is still going to be 'business as usual.'" Chan declined to comment on whether the possible delisting in Hong Kong will affect other Asian regions. Lyxor ETFs are also listed in Singapore. He declined to provide further information about Thai or Indonesian ETFs.

SocGen recently fuelled rumors of a delisting with a statement made to the **Hong Kong Stock Exchange** in early November that it was reviewing its strategy for its Lyxor ETFs. The firm has



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been offering a range of synthetic ETFs since 2007 to Hong Kong. According to Hong Kong's **Securities and Futures Commission**, the firm has about 12 ETFs registered.

"At the moment we are considering different strategies," Chan told *DW*. "The different strategies may or may not lead to the final decision that we are going to delist all the ETFs in Hong Kong." He said certain factors, such as the efficiency of the business and whether SocGen had enough clients to beef up its franchise in Asia, still needed to be considered.

A hedge fund investor said SocGen's main issue is it came late to the Asian ETF market. She said the firm entered the market and started issuing similar EFTs to funds already in the market in order to wrestle market share away from more established rivals.

## Indian Manager Plots Usage

**Indiabulls Asset Management Company**, an asset manager based in Mumbai, is planning to launch an open-ended equity fund that can use fixed income derivatives, such as interest rate and credit default swaps, to hedge interest rate and credit risk.

Indiabulls has filed offer documents with the **Securities and Exchange Board of India** for the Indiabulls Tax Saver Fund. The funds will invest in equity, equity securities, debt and money market instruments. The fund will use derivatives for hedging purposes, the filing stated.

Indiabulls is the financial services subsidiary of **Indiabulls Group**, which was founded in early 2000.

The current assets under management at Indiabulls could not be determined. A spokesperson did not return calls seeking further information.

## RBS Eyes Long Nikkei, Short S&P Vol Swap



Kevin Chang

Strategists at the **Royal Bank of Scotland** are advising investors buy four-year variance swaps on the Nikkei 225 and sell four-year variance swaps on the S&P 500.

The trade is designed to take advantage of a premium of three-year S&P variance over three-year Nikkei variance. "Despite the fact that over any three-year period since late 1990,

the Nikkei has realized higher volatility than the S&P," according to **Kevin Chang**, head of equity derivatives strategy, Asia. "When the idea was proposed on Wednesday, the spread in three-year variance swaps was around 1.5 vol bid, S&P over Nikkei, with a typical trade size being about USD50,000-100,000 of vega."

Since 1990, three-year realized vol on the Nikkei has always exceeded the S&P 500. The three-year realized spread averages 7 vols and has always been at least 2 vols, which is 3.5 vols over the current bid in variance swaps, according to RBS data.

"In the past 24 hours, we've had some client interest, but

overnight the markets have calmed down a lot and implied vols have fallen more on the S&P than on the Nikkei," said Chang. "So that spread has come in by roughly 1 vol and in fact the trade would have made money already." At press time, S&P vol was bid at 1.05 over the NKY for Dec. 2014 variance swaps. "So it makes sense to go long NKY variance and short SPX variance at this tenor," said Chang.

## People & Firms

### NY Hedge Fund Nabs RBS Strategist

New York hedge fund **Brigade Capital Management**, which is headed by **Donald Ellis Morgan**, has brought on **Thadeus Strobach**, a former managing director of credit strategy covering credit derivatives at the **Royal Bank of Scotland** in New York. He is a senior analyst covering the energy and power industries.

Reached at the USD1.2 billion manager, Strobach declined to comment. According to people familiar with his departure, Strobach left RBS last month to take the new spot. He had been with RBS since August 2009. RBS and Brigade officials declined to comment.

### MD Exits Nomura

**Hector Cortes**, a managing director in fixed income institutional sales at Nomura, has left the firm within the last few weeks.

Cortes worked for **Lehman Brothers** for 16 years, finishing his tenure as a senior vice president and a distributor of structured products and bonds. He then worked at **Bank of America** until the end of 2007 as a managing director and head of global rates commodities currencies third party distribution for U.S. Treasuries, government sponsored enterprises, and structured notes.

Cortes could not be reached for comment. Reporting lines could not be immediately gleaned. A spokesman at the firm declined comment.

### Clarke Set To Join Goldman

**Michael Clarke**, formerly global head of counterparty risk management at **UBS** in New York, is set to join **Goldman Sachs** in a similar role. Further details as to starting date, exact title, and reporting lines could not be immediately gleaned, but Clarke confirmed the planned move.

Clarke has been on gardening leave since leaving left UBS (DI, 11/4). Previously, he spent two years at **Deutsche Bank** as global head of collateral management and client valuations from 2002-2005. He is also chair of the **International Swaps and Derivatives Association's** Collateral Committee, which is in the process of developing and rolling out a new standard credit support annex next year.

Spokespeople at Goldman did not immediately return calls for comment. A spokesman at UBS was unaware if Clarke's position had been filled.

## Learning Curve®

### E.U. Naked CDS Ban: A Bark Worse Than Its Bite

The European Parliament threatened a blanket ban on credit default swaps in E.U. member states, identifying them as a major contributor to current eurozone instability. The compromise text which has now been adopted is considerably less alarming than that. Most hedging purposes for which sovereign CDS are currently used are protected; it is only the truly speculative activities which will be prohibited.

On Nov. 4 the E.U. Council published the text of the Proposal for a Regulation on Short Selling and certain aspects of Credit Default Swaps as provisionally agreed between the E.U. Council and E.U. Parliament on Oct. 18. This text was adopted by the EU Parliament on Nov. 15 and the Regulation is expected to enter into force Nov. 2012.

The regulation includes a prohibition of “uncovered” or “naked” CDS referencing E.U. sovereigns. The Council and the European Commission had previously sought to impose an obligation merely to notify significant positions in naked sovereign CDS, with member states retaining the power to impose a temporary outright ban only if the CDS market presented a serious threat to its financial stability or to market confidence in the member state.

By contrast, the Parliament had argued for an outright ban of uncovered sovereign CDS. The final form of the regulation provides a welcome compromise between the two views. Naked sovereign CDS are indeed banned, but there is a much more limited understanding of what is “naked.” In essence, any sovereign CDS entered into for the purposes of hedging the default risk of a member state, of a government entity or even a private sector entity, should now be outside the ban. Only the truly speculative activities made through sovereign CDS are to be prohibited.

#### Article 4 – Definition Of Uncovered CDS

Article 4 provides that a person has an uncovered position in a sovereign CDS if the CDS does not hedge against either:

(a) the risk of default of the state where the person has a long position in its sovereign debt, or

(b) the risk of a decline of the value of the sovereign debt where the person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is correlated to the value of the sovereign debt.

This wording is already slightly broader than previously proposed, and introduces the possibility of a hedge arising from financial contracts which have a value correlated to the value of the sovereign debt.

#### Broader Understanding Of Exposure

The real compromise of the regulation is to be found in Recital 21 which continues to acknowledge that an underlying exposure to sovereign risk can arise other than through bond ownership, and now gives a much broader understanding to when such an exposure can be recognized.

The key points are:

- The regulation acknowledges that exposure may arise under financial contracts and portfolios of assets or financial obligations—which we take to mean that hedging of synthetic exposures is permitted;
- The regulation specifically acknowledges that CDS may be used as a counterparty risk management tool for hedging exposure on financial and foreign trade contracts;
- No position used in the context of hedging exposures to a sovereign shall be considered an uncovered position in a sovereign credit default swap.
- References to an exposure to the member state also include (a) exposures to the central, regional and local administration, public sector entities or any exposure guaranteed by any such entity; and (b) exposure to private sector entities established in the member state. All exposures shall be considered in this context including i.e. loans, counterparty credit risk (including potential exposure when regulatory capital is required to such exposure), receivables and guarantees.
- Indirect exposure arising through funds, indices or SPVs is also acknowledged.

The effect of this broadening of the concept of exposure is to commensurately narrow the universe of ‘uncovered’ CDS, which is then prohibited.

As one would expect, the drafting is not crystal clear. In particular it does seem to distinguish between CDS which are hedging market value risk, which enjoys the broad description of exposure outlined above, and CDS which are hedging default risk, which continues to refer only to long positions in sovereign debt. However, given the way a credit default swap is defined and the clear purpose behind Recital 21, we think that this should not be interpreted narrowly.

The regulation will be supplemented by more detailed guidance, on which the **European Securities and Markets Authority** has been charged to provide advice. This will include



Paul Cluley



Christine Long

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the tests for correlation included in Article 4. It is to be hoped that ESMA's contribution to the guidance will be in line with the narrow concept of "uncovered" which is clearly contemplated by the Recital, and that they will not seek to increase the scope of the prohibition.

### Other Features Of The Regulation

The regulation also permits a member state to suspend the restrictions on uncovered CDS if it believes that this is causing the sovereign debt market to cease to function properly or will increase the cost of borrowing for sovereign issuers. The regulation provides some parameters for the making of any such determination. As with earlier drafts of the regulation, a member state also retains the power *in extremis* to limit or ban all sovereign CDS, whether uncovered or not, subject to the oversight of ESMA.

CDS positions in place at the time that the regulation comes into force are grandfathered. And the definition of "sovereign issuer" is extended to include bodies such as the European Financial Stability Facility. As previously proposed, there will remain a daily obligation to notify the relevant competent authority of significant short positions in sovereign debt, including where such short positions arise through sovereign CDS. In the case of a single name sovereign CDS, it is the competent authority of the sovereign reference entity that must be notified. ESMA is to provide advice on the appropriate thresholds and mechanics for such notification.

### Conclusion

The regulation represents a considerable dilution of the draconian

prohibition that had been proposed by the E.U. Parliament. By greatly widening the range of exposures which may be taken into account in assessing the meaning of "uncovered," it protects CDS transactions entered into:

- to hedge exposure to sovereign debt;
- to hedge exposure to sovereign credit risk arising under back-to-back positions, portfolio CDS and indices;
- as part of customary counterparty risk management exercises to manage credit exposures to the
- sovereign under a wide range of loans, derivatives and guarantees;
- where the default risk of the sovereign is used as a proxy for exposure to governmental institutions, or even private sector counterparties.

It seems that as a general rule, transactions which have as their broad purpose the hedging of risk of sovereign default, or correlated risks, are protected. Only truly speculative transactions are to be prohibited. This appears to us to be a much more proportionate response, particularly given the number of reports (and indeed the press release issued by the Commission in October) which have acknowledged that short selling, including the entry into sovereign CDS were not the cause of the current economic conditions in the eurozone, even if they have the potential to aggravate price declines in distressed markets.

*This week's Learning Curve was written by Paul Cluley, a partner, and Christine Long, a professional support lawyer, at Allen & Overy in London.*

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## Equity Markets

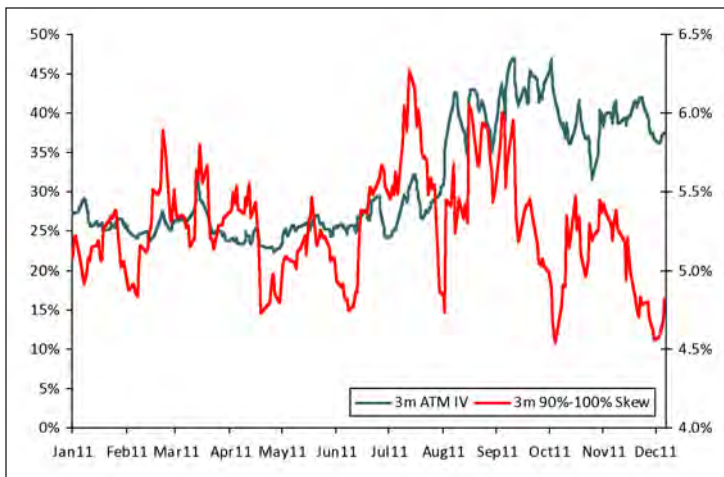
### Low Skew Continues

By **Chetun Patel**, macro strategist at **Mariana Capital Markets**

With the continued uncertainty, markets remain very jittery with daily swings continuing to be very high compared to the past behaviour of indices.

In the volatility markets, we are seeing a similar dynamic, with volatility of volatility still very high and the absolute level of volatility continuing to trade at extended levels, which is especially unusual considering the seasonality at this time of year. One dynamic which continues to be a surprise is the level of downside skew, which suggests buying protection is cheap compared to the cost of upside options in the current environment, as seen in Figure 1 for the EuroStoxx50.

Figure 1

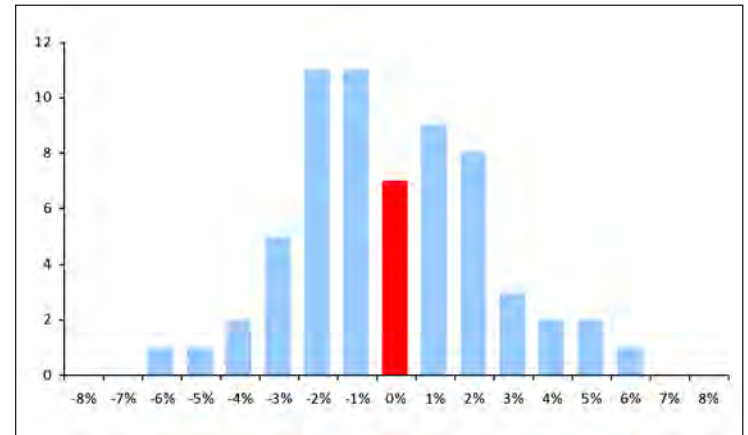


This characteristic of the volatility is not that surprising in bear markets which are facing significant central bank intervention, where arguably the skew should be inverted, or at least flat. This is because the market is as likely to have large moves to the upside as they are to the downside.

We saw a very similar dynamic during the 2008 crisis, where markets tended to rally very sharply almost with equal frequency to large moves to the downside. If we consider the dynamic of the market since September, we can see the realised skew of the

market being positive for the market as generally it has tended to have smaller moves to the downside, with large moves to the upside. The distribution is illustrated in Figure 2.

Figure 2



Looking at this distribution, we see the average return is clearly negative over the period, but the skew is positive with a significant number of large positive returns. This is unusual compared to the distribution of stock returns in a more “normal” environment, where we tend to see a negative skew as stocks tend to drift higher and fall down. This recent dynamic would justify the pricing of skew as currently observed, despite huge uncertainty still outstanding in the market. This is illustrated by the current high level of implied volatility, but with a more even distribution of skew for the near term.

Another effect which has caused this reduction in skew has been driven by a large amount of buying in upside call options to try to capture any large spikes in the market with a limited risk to the downside if the market continues to face further weakness. This demand for the upside options causes skew to weaken by upside being priced more expensively compared with downside.

So this cheap protection we observe in the market, based on traditional measures, is not driven by protection being cheap at all, since outright implied volatility is significantly higher. It is more a reflection of the expected return distribution in coming months and demand dynamics altering the volatility surface to give this appearance.

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## Sovereign Credit Markets

### High Stakes

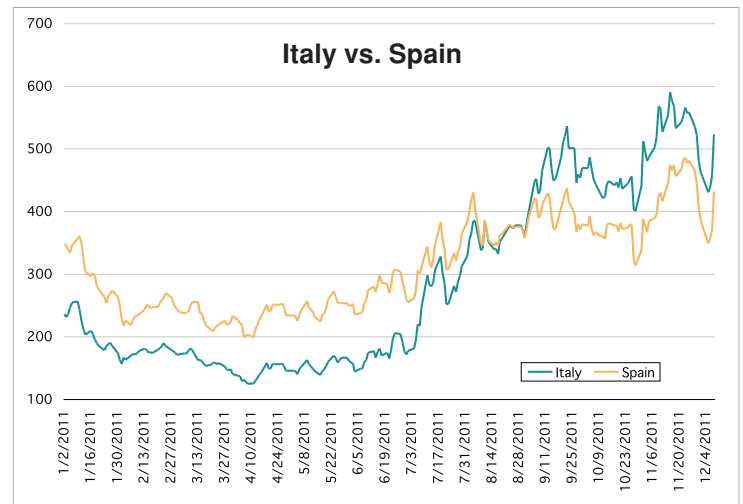
By **Gavan Nolan**, credit analyst, **Markit**

Cautious optimism had been building throughout the week in the sovereign credit markets ahead of the **European Central Bank** meeting on Thursday and the EU summit on Friday. Economic data had little impact on sentiment as traders reacted to the plethora of headlines emanating from Europe. The markets seemed confident that European policymakers had found a new sense of urgency and they were finally ready to cross the rubicon.

But their optimism was punctured on Thursday by ECB President **Mario Draghi**. He unveiled a series of non-standard measures aimed at easing liquidity conditions in the European banking sector. These included two long-term refinancing operations of 36 months; the previous LTROs were one-year in duration. Draghi also announced a relaxation of collateral rules and a 1% cut in the reserve requirement ratio. The change in LTROs and collateral were expected, though the reserve requirement cut was something of a surprise. All were welcomed by the market and spreads rallied soon after the announcement.

But they rapidly went into reverse and Draghi was again responsible for shifting market sentiment. In response to questions at a press conference the ECB president played down his "other elements" comment last week. This referred to his hint that if a "fiscal compact" was put in place then the ECB may be willing to provide further help to struggling sovereigns; interpreted by many in the markets as an aggressive program of buying peripheral debt. Draghi said he was surprised at how some elements of the media reported his comments.

That wasn't the end of it. He later stressed that the ECB is not



Source: Markit

allowed to monetize government debt, either directly or through the IMF. The latter idea had emerged as one of the favorites to be announced at Friday's crucial summit. Specifically, it was thought that national central banks would lend bilaterally to the IMF which would then lend to eurozone governments. But Draghi said this wouldn't be compatible with the "spirit of the treaty" and that money channels cannot circumvent treaty provisions.

Given the optimism that has been building this week it was understandable that the markets received Draghi's comments badly. The Markit iTraxx SovX WE was 33bp wider at 365bps, Italy and Spain capitulated and broke through 500bps and 400bps respectively and core eurozone countries also widened sharply. The outcome of Friday's summit, unknown at the time of writing, will be the main driver of spread direction for months to come.

### ESMA Group (Continued from page 1)

group's recommendations in a consultation to be released in the New Year.

In relation to the quality of collateral in synthetic ETFs, the SMSG advised that qualitative and quantitative requirements should be set up to ensure that collateral is sufficiently liquid. It proposed that 70% of collateral should be made up of listed assets such as large caps. "In requiring that the majority of the collateral be made out of listed assets, the valuation issues arising in respect to the collateral will be solved, since the valuation of 70% of the collateral will correspond to stock market prices," it noted.

The SMSG highlighted securities lending as one of the most critical issues on terms of bringing greater transparency to ETFs. "Lending and borrowing should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, because the risks [are] heightened and the tracking of the

underlying is made more difficult," it said.

The group also called for a minimum level of over-collateralization when the ETF index type and collateral are not significantly correlated. The majority of its members recommended that regulators should be given the power to regularly control the quality of collateral throughout the life of the ETF.

The advice comes as regulators globally are looking closer at ETFs, particularly in relation to selling practices and the risks involved in such products. Firms too have been weighing in on the issue, with iShares, the exchange-traded funds provider managed by **BlackRock**, for example, proposing tougher transparency and disclosure requirements in ETF products (DI, 10/6). Spokespeople at BlackRock did not return calls or e-mails seeking comment on the SMSG's advice.

The majority of the SMSG also noted that prohibitions should be put in place in cases where entities in the same group act a dual role as the synthetic ETF provider and derivative counterparty,

although a minority argued that necessary restrictions already exist. Other advice centered on summaries of index-tracking issues, the appropriateness of an identifier in distinguishing between synthetic, physical and actively managed ETFs, and whether swap-based ETFs should be excluded from the Markets in Financial Instrument's Directive scope of products that can be provided on an execution only basis. The group also discussed whether regulators should be given the power to ban the distribution of certain ETFs to retail clients, or whether the distribution of synthetic ETFs to retail investors should be scrapped altogether, although a final recommendation was not reached.

The MSG is made up of 30 representatives of financial market participants, and is chaired by **Guillaume Prache**, managing director of the **Federation of European Investors**. Its members include **Xavier Rolet**, ceo of the **London Stock Exchange**, and **Sally Dewar**, a managing director at **JPMorgan** and former board member of the U.K. **Financial Services Authority**.

ESMA plans to release a further consultation on ETFs in the New Year. —**Rob McGlinchey**

## HK Legislators (Continued from page 1)

the Code of Conduct for Persons Licensed by or Registered with the **Securities and Futures Commission**.

Market officials argued, however, that such an amendment would have meant the professional investor exemption in the rules would have been difficult to rely on. The professional investor exemption allows sophisticated and active professional investors to access a wider range of products not available to the general public.

**Yvonne Siew**, partner at **Allen & Overy** in Hong Kong, welcomed the rejection of the amendment, saying its wording would not have worked had it been implemented. "I think the fact that it didn't go through left all of us breathing a sigh of relief," she said. The amendment was trying to make clear regulation surrounding categorization and thresholds for high-net-worth professional investors. "But the actual categorization wouldn't really work as hardwired legislation."

The **International Swaps and Derivatives Association**, which welcomed the LegCo move, said the amendments would have alienated investors and restricted the range of products available to them in Hong Kong. The change to the Securities and Futures (Professional Investor) Rules would also have reduced Hong Kong's competitiveness in the region

In a letter to the Legislative Council, ISDA said the exemption plays a vital role in bringing a wide variety of structured products to the Hong Kong market. "The exemption plays a vital role in bringing a wide variety of structured products to the market and its importance continues to be reflected in the recent reforms to the restrictions relating to the offer of structured products under the Securities and Futures Ordinance," ISDA said in the letter.

Kam did not respond to e-mails or calls. It could not be determined if he plans to introduce similar legislation in the future.

—**Daniel O'Leary**

## Funds Scoop (Continued from page 1)

options with one-month tenors for the barriers. If the knock-out or both knock-outs are not hit after one month, the barrier disappears. The point of adding window barriers is to cheapen the depreciative view on the euro for the three-month tenor.

The strikes were placed from USD1.34 down to 1.30. The barriers on the downside have been set from USD1.30 down to 1.25, while topside barriers when added were around USD1.40. The notionals have been medium-sized for both types of structures, said an fx exotics structurer based in Stamford, Conn., which would mean in the USD100-200 million range.

Hedge funds have also been buying one-month calls on the cross with strikes at USD1.36. Combined with the window barriers, this trading represents overall investor sentiment that the market is too bearish on the euro, as related to the eurozone debt crisis, and the euro will likely strengthen by year end.

"People are taking off some of their extreme short downside euro bets and it feels like there's almost a sense of resignation to the idea that the euro isn't going to collapse yet," said **Kit Juckes**, head of foreign exchange strategy at **Société Générale** in London. "Everyone is aware of the wall of funding that has to be done in January and February [to keep the euro alive] but even the people expecting to be disappointed by the European summit next week aren't expecting a massive crisis this side of Christmas."

Spot on the cross sat at USD1.33 at press time. One-month implied volatility sat at 14%, while three-month implied volatility sat at 14.9%.

—**Mike Kentz**

## Events

- The **Futures Industry Association** will hold its 37th annual International Futures Industry conference on March 13—16, 2012 at the **Boca Raton Resort & Club** in Florida. Conference attendees will include officials from banks, exchanges and money managers, as well as members of congress, with delegates from more than 30 countries. For further information, visit [www.futuresindustry.org](http://www.futuresindustry.org).

- The **International Swaps and Derivatives Association** has changed the location of its 27<sup>th</sup> Annual General Meeting. The AGM was previously going to be held in New Delhi, India, but will now be held at the Fairmont Chicago Millennium Park in Chicago, U.S., between April 30—May 2, 2012. The Association noted that it plans to host an AGM in India in the near future.

## Quote Of The Week

*"Everyone is aware of the wall of funding that has to be done in January and February [to keep the euro alive] but even the people expecting to be disappointed by the European summit next week aren't expecting a massive crisis this side of Christmas."*—**Kit Juckes**, head of foreign exchange strategy at **Société Générale** in London, on why some market participants are taking off some of their short downside euro trades (see story, page 1).